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Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term, 1996

In the Matter of SOUTHMARK CORPORATION,

Debtor.

SCHULTE ROTH & ZABEL,

Petitioner,

v.

SOUTHMARK CORPORATION,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether the existence of a "claim" under section 101(5) of the Bankruptcy Code always creates an "antecedent debt owed by the debtor" under section 547(b)(2) of the Bankruptcy Code.

II. Whether a debt can be owed before it is incurred.

LIST OF PARTIES

The following persons were parties to the proceedings in the Bankruptcy Court, District Court and Court of Appeals:

1. Petitioner/Defendant Schulte Roth & Zabel, a New York partnership

2. Respondent/Plaintiff Southmark Corporation

In accordance with Supreme Court Rules 14.1(b) and 29.6, Plaintiff Southmark Corporation has no parent company but has the following subsidiary corporations:

Care Centers, Inc.
Dominion Subsidiary Co.
Envicon Development Corp.
HCW Gas Processors, Inc.
Johnstown American Subsidiary Corporation, No. 3
Johnstown Investment Corp.
Monument Investments, Inc.
Riviera Utilities of Arkansas, Inc.
Southmark Acquisitions, Inc.
Southmark Acquisitions Canada LTD.
Southmark Commercial Management, Inc.
Southmark Financial Services, Inc.
Southmark Hospitality Management, Inc.
Southmark International, NV
Southmark Investment Group, Inc.
Southmark Life Group, Inc.
Southmark Life Subsidiary Corp.
Life Group Associates II, Inc.
Robert A. McNeil Corp.
Pacific Income Plan Company of California

LIST OF PARTIES – Continued

Pacific Investors Corp.
Southmark PS, Inc.
Southmark San Juan, Inc.
Southmark/Security National Investment Corp.
First Associated Management, Inc.
Southmark Tek, Inc.
North American Mortgage Investors
First HCW Pension Real Estate, Inc.
Southmark Investors, Inc.
Southmark Management Corp.
University Advisory Company, Inc.
SPC Holding Co.
Devam Corp.
Southmark Pacific Corp.
Pennpacific Properties, Inc.
Sopac Development Co.
West Texas Working Interest Corp.

The following additional persons were parties to the proceedings before the Bankruptcy Court and District Court who settled prior to oral argument before the Court of Appeals:

Defendant Garson L. Rice, Sr.
Defendant R&P Ventures, a North Carolina joint venture

The following persons were parties to the original Bankruptcy Court proceeding who were non-suited after each filed for bankruptcy:

Defendant Herbert B. Parks
Defendant Byron Investments, Inc.

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PETITION FOR WRIT OF CERTIORARI

Petitioner respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in the above-titled proceeding on July 2, 1996.

OPINIONS BELOW

Copies of the following Orders and Opinions are reprinted in the Appendix attached hereto:

1. Memorandum Opinion of the United States Court of Appeals for the Fifth Circuit entered on July 2, 1996 (*Southmark Corp. v. Schulte Roth & Zabel*, 88 F.3d 311 (5th Cir. 1996))
2. Memorandum Opinion and Order entered by the United States District Court for the Northern District of Texas, Dallas Division on September 6, 1995 (unpublished)
3. Order Granting Defendants' Summary Judgment Motions and Granting in Part and Denying in Part Plaintiff's Cross-Motion on Certain Issues entered by the United States Bankruptcy Court for the Northern District of Texas, Dallas Division on April 5, 1993 (unpublished)
4. Order Denying Petition for Panel Rehearing and Suggestion for Rehearing En Banc entered by the United States Court of Appeals for the Fifth Circuit on August 1, 1996 (*Southmark Corp. v. Schulte Roth & Zabel*, 95 F.3d 56 (5th Cir. 1996))

JURISDICTION

The decision of the Court of Appeals for the Fifth Circuit was rendered on July 2, 1996 and the Petition for Rehearing and Suggestion for Rehearing En Banc were denied on August 1, 1996. Jurisdiction over this Petition is conferred by 28 U.S.C. § 1254.

This case was originally filed as an adversary proceeding in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division as part of the bankruptcy case entitled *In re Southmark Corporation*, bankruptcy case no. 389-36324-SAF-11. The Bankruptcy Court had jurisdiction over the adversary proceeding under 28 U.S.C. § 1334(a) and because the matter constituted a core proceeding arising under title 11, 28 U.S.C. § 157(b)(2)(F). The District Court had jurisdiction over the appeal of the Bankruptcy Court's ruling under 28 U.S.C. § 158(a) and the Court of Appeals had jurisdiction over the appeal of the District Court's ruling under 28 U.S.C. § 158(d).

STATUTES INVOLVED

11 U.S.C. § 547(b) (Section 547 of the Bankruptcy Code) (emphasis on relevant section of statute)

§ 547. Preferences

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 101(5) and (12) (Sections 101(5) and (12) of the Bankruptcy Code)

§ 101. Definitions

(5) "claim" means –

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

* * *

(12) "debt" means liability on a claim; . . . .

STATEMENT OF THE CASE

Respondent Southmark Corporation ("Respondent" or "Southmark") filed for chapter 11 bankruptcy on July 14, 1989. Its Plan of Reorganization (the "Plan") was confirmed and subsequently became effective on August 10, 1990. Pursuant to the Plan, Southmark, as reorganized, became responsible for pursuing all causes of action of the former chapter 11 debtor. The adversary proceeding underlying this appeal was commenced on June 19, 1991 in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division (Felsenthal, J.) (the "Bankruptcy Court") to recover, *inter alia*, a certain $3.3 million alleged preferential

transfer[1] made to or for the benefit of the Defendants R&P Ventures ("R&P"), Garson L. Rice, Sr. ("Rice"), Herbert B. Parks ("Parks") and Byron Investments, Inc. ("Byron") (collectively, the "Parks Group"). Petitioner Schulte Roth & Zabel ("Petitioner") is a law firm, which was retained to represent the Parks Group in its pre-bankruptcy proxy contest against Respondent.[2]

The defendants answered the complaint, denying, *inter alia*, that the $3.3 million transfer was "for or on account of an antecedent debt owed" by Respondent before the transfer was made, as required by 11 U.S.C. § 547(b)(2), and raising various affirmative defenses. Subsequently, Petitioner and the remaining Parks Group defendants filed Motions for Summary Judgment on the antecedent debt issue. Respondent filed a Cross-Motion for Summary Judgment on section 547(b)(2), as well as on all other elements of 11 U.S.C. § 547(b).

The Bankruptcy Court heard oral argument on these Motions, and on April 5, 1993, granted Respondent's Motion in regards to all elements of section 547(b) *except* (b)(2). On this issue, the Bankruptcy Court determined that the $3.3 million transfer had *not* been on account of an antecedent debt owed by Respondent before the transfer was made, and therefore, summary judgment should be granted for Petitioner and the other defendants because Respondent could not meet its burden of proof on one of the essential elements of a preference with respect to the $3.3 million transfer. Appendix, pp. A-35-A-49. The Summary Judgment Order was interlocutory at the time it was rendered, but was certified for appeal.

Respondent appealed this ruling to the United States District Court for the Northern District of Texas (Kendall, J.)

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[1] The original and amended complaints included causes of action for the recovery of three other transfers which causes of action were settled and are not relevant to any appeal.

[2] Parks and Byron were nonsuited after each filed for bankruptcy. R&P and Rice settled prior to oral argument before the Fifth Circuit, leaving Petitioner as the only remaining Defendant.

(the "District Court"), who affirmed it[3] on September 6, 1995. Appendix, pp. A-18-A-34. Respondent appealed to the Fifth Circuit the District Court's ruling on both the Summary Judgment Order and the denial of its Motion for Leave to Amend. Oral argument was held on April 30, 1996.

On July 2, 1996, a Panel consisting of Chief Judge Politz, and Circuit Judges Wiener and Barksdale issued an opinion affirming the Bankruptcy Court's denial of the Motion for Leave to Amend, but reversing and remanding the Summary Judgment Order, holding that the alleged preferential transfer was made for or on account of an antecedent debt. Appendix, pp. A-1-A-17. Petitioner filed a Petition for Panel Rehearing and a Suggestion for Rehearing En Banc on July 16, 1996. Both were denied by Order entered August 1, 1996. Appendix, pp. A-50-A-51.

BACKGROUND FACTS[4]

This case has its roots in a proxy contest waged by the Parks Group, a group of dissatisfied shareholders of Southmark. Petitioner was counsel to the Parks Group. In March 1989, the Parks Group disclosed to the Securities and Exchange Commission ("SEC") its intention to propose nominees for election to Southmark's board of directors. In April

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[3] The Fifth Circuit appeal was actually two consolidated appeals. Prior to the Summary Judgment Order, the Bankruptcy Court had denied a motion by Respondent for leave to amend its complaint for the second time. After the Summary Judgment Order was appealed, all other causes of action remaining before the Bankruptcy Court were settled, and the Summary Judgment Order became a final judgment. Respondent then appealed the denial of its Motion for Leave to Amend, which was consolidated with the appeal of the Summary Judgment Order by the District Court. The District Court affirmed both Bankruptcy Court rulings.

[4] The issue in this case has always been one of law. The facts have never been disputed by the parties and, therefore, detailed citations to the factual record, set out at length in the briefs filed with the Fifth Circuit, have been omitted.

1989, the Parks Group publicly announced its intention to wage a proxy contest for the control of Southmark. Shortly thereafter, the Parks Group disseminated several statements expressing dissatisfaction with the activities of Southmark's then-current board of directors regarding, among other things, issues of corporate governance and management, executive/director compensation and transactions between the company and its directors and executives. In these SEC filings, the Parks Group indicated that it intended, to the extent legally permissible, to seek reimbursement of its costs and expenses incurred in connection with the proxy contest, and gave periodic estimates of these costs and expenses, all as required by applicable SEC regulations.

Between February and May 1989, each of the Parks Group and Southmark initiated various lawsuits in state and federal courts in connection with the proxy contest. Through its claims and counterclaims in the lawsuits, the Parks Group sought the following: (1) equitable and injunctive relief including the right to examine Southmark's record of shareholders, and (2) judgments (a) blocking the implementation of, and declaring null and void, a Southmark anti-takeover "poison pill" provision, (b) prohibiting Southmark directors from soliciting proxies unless specific disclosures were made, (c) directing Southmark directors to cure certain deficiencies in their proxy statement, and (d) forcing Southmark and its directors to refrain from postponing a scheduled shareholders' meeting.[5] In two of its lawsuits and in one of its counterclaims, the Parks Group, in a boilerplate prayer for relief, requested that it be awarded the costs and disbursements, including reasonable attorneys' fees, incurred in these lawsuits.

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[5] In only one of the lawsuits, the Parks Group sought, in addition to injunctive relief, monetary damages in connection with the threatened postponement by the Southmark board of a scheduled shareholders' meeting. The Parks Group *only* sought that relief from the directors of Southmark personally, and *not* from Southmark itself.

An overall settlement of the proxy contest and related litigation was reached and documented by May 24, 1989. The substance of the settlement is more fully described in the Settlement Agreement dated May 24, 1989 (the "Settlement Agreement"), entered into between Southmark, the Parks Group, and certain other individuals. Petitioner was not a party to the proxy contest, any of the lawsuits or the Settlement Agreement. The Settlement Agreement provided for, *inter alia*, the termination of the proxy contest, a voice on the Southmark board for minority shareholders (including the Parks Group), the appointment of three nominees of the Parks Group to the Southmark board, the inclusion for two years of the current nominees in the board's slate of nominees recommended for election, the agreement by the Parks Group not to engage in a proxy solicitation in opposition to Southmark or other takeover activities and the settlement and dismissal with prejudice of the lawsuits. The Settlement Agreement also provided that upon execution, Southmark would reimburse the Parks Group for its costs and expenses, including attorneys' fees, incurred in connection with the proxy contest and related corporate governance litigation. The parties estimated these expenses to be $3.3 million.

Midday on May 24, 1989, prior to the execution of the Settlement Agreement by all the parties, Southmark transferred $3.3 million to Petitioner by wire transfer. In this instance, Petitioner was acting essentially as an escrow agent as an accommodation to Southmark. Petitioner was under instructions to return these funds to Southmark in the event the Settlement Agreement was not formally executed. The Settlement Agreement was formally executed later, early in the evening on May 24, 1989. On May 25, 1989, Petitioner transferred the entire $3.3 million to R&P by wire, R&P wrote checks for certain of the funds to Byron and Byron wrote a check to Petitioner in the amount of $1 million.[6] Southmark filed for bankruptcy less than 90 days later.

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[6] Respondent, in its amended complaint, has acknowledged that Petitioner is not an initial transferee of the $3.3 million. 11 U.S.C.

Subsequently, after confirmation of its Plan, Southmark filed suit against the Parks Group and its law firm, the Petitioner, to recover the $3.3 million transfer. The Fifth Circuit, in reversing the Bankruptcy and District Courts, determined that the $3.3 million transfer was for or on account of an antecedent debt owed by Southmark. The Fifth Circuit's conclusion in this case, that a debt can be owed before it is incurred (that is, before the contingency that triggers liability takes place), is in conflict with the plain meaning of the statute, the legislative history of the statute, and the decisions of other circuit courts and numerous lower courts and should be reviewed by this Court.

REASONS FOR GRANTING THE WRIT

To be avoidable as a preferential transfer under the Bankruptcy Code (11 U.S.C. § 101, *et seq.*), a transfer must be "for or on account of an *antecedent debt* ***owed*** by the debtor before such transfer was made." 11 U.S.C. § 547(b)(2) (emphasis added). The fundamental issue involved in this case is whether a contingent claim always constitutes an "antecedent debt **owed**" prior to the time the contingency occurs. A writ of *certiorari* is necessary because:

1. This issue has been inconsistently decided by the circuit and lower courts resulting in a confusing and conflicting body of case law regarding a fundamental principle of the Bankruptcy Code. These inconsistencies can only be resolved by this Court.

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§ 550(a)(1). The issue of whether or not Petitioner is some type of subsequent transferee of any portion of the $3.3 million from whom Respondent can recover a preference under 11 U.S.C. § 550(a) was never reached by the Bankruptcy Court because the Bankruptcy Court found that the transfer was not a preference under 11 U.S.C. § 547(b). This issue will now have to be resolved at trial by the Bankruptcy Court.

2. The Fifth Circuit misconstrued prior rulings of this Court and effectively nullified one half of section 547(b)(2) in direct disregard of the plain meaning of the statute and all principles of statutory construction as frequently enunciated by this Court. Entire provisions of a statute should not be completely disregarded by the Fifth Circuit and other courts.

3. By ignoring the legislative history of section 547(b)(2) that an antecedent debt must be **"owed,"** the Fifth Circuit has resurrected problems corrected by the adoption of the Bankruptcy Code in 1978. The statute should be applied as written by Congress, not as inconsistently rewritten by the Fifth Circuit and certain other lower courts.

I. In conflict with the plain meaning of the Bankruptcy Code, decisions of other Circuits and with its own prior decision, the Fifth Circuit has determined that a contingent claim constitutes a debt owed by the debtor prior to the occurrence of the contingency.

"And they all spoke at once, so that none of them knew
One word that the other had said."[7]

The Fifth Circuit held, in the opinion below, that the Parks Group's contingent claim for recovery of costs and attorneys' fees incurred in connection with a proxy contest and related corporate governance litigation constituted a *debt owed* or *incurred* by Southmark as of the date the Parks Group stated its intent to seek such reimbursement in the event it was successful – rather than as of the date the board of directors of Southmark contractually agreed to reimburse such expenses. Appendix, pp. A-13-A-14. Therefore, according to the Fifth Circuit, such debt was antecedent to its

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[7] LEWIS CARROLL, THE HUNTING OF THE SNARK: THE BARRISTER'S DREAM (London, Macmillan and Boston, Osgood 1876).

payment, and the $3.3 million transfer constituted a preference. Appendix, p. A-16.

The Fifth Circuit reached this conclusion by analyzing the Bankruptcy Code's definitions of "claim" and "debt," noting that "claim" is defined at section 101(5) of the Bankruptcy Code as a "right to payment," even if the right to payment is contingent upon the occurrence of a future event. "Debt," however, is defined in section 101(12) of the Bankruptcy Code as "*liability* on a claim" (emphasis added). Citing to the legislative history of section 101(12) and certain case authority, the Fifth Circuit concluded that a claim, even if contingent, always simultaneously results in the incurrence of a debt because the "terms 'debt' and 'claim' are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." Appendix, p. A-15 (*citing, e.g., Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 558 (1990)). Thus, the Fifth Circuit ignored the plain meaning of the statute and concluded that a debt can be "antecedent" and "owed" before it is incurred.[8]

Every court that has dealt with this issue agrees that, to determine if a payment is made for or on account of an antecedent debt owed by the debtor, the date the debt was incurred must be compared with the date the transfer

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[8] The Fifth Circuit based its decision on two cases which actually contradict its holding: *Energy Cooperative, Inc. v. SOCAP Int'l, Ltd. (In re Energy Cooperative, Inc.)*, 832 F.2d 997 (7th Cir. 1987) and *Southmark Corp. v. Marley (In re Southmark Corp.)*, 62 F.3d 104 (5th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 815 (1996). The Fifth Circuit failed to consider another case that supports its holding: *Upstairs Gallery, Inc. v. Macklowe West Dev. Co., L.P. (In re Upstairs Gallery, Inc.)*, 167 B.R. 915 (B.A.P. 9th Cir. 1994). Circuit Court cases which directly or, in effect, contradict the holding of the Fifth Circuit in the case at bar include: *Sigmon v. Royal Cake Co., Inc. (In re Cybermech, Inc.)*, 13 F.3d 818 (4th Cir. 1994); *Kallen v. Ash, Anos, Freedman & Logan (In re Brass Kettle Restaurants, Inc.)*, 790 F.2d 574 (7th Cir. 1986) and *Sunset Enters., Inc. v. B&B Coal Co.*, 38 B.R. 712 (W.D. Va. 1984), *aff'd*, 798 F.2d 1409 (4th Cir. 1986).

occurred.[9] However, in cases involving contingent claims, the courts have ignored the statutory language and no uniform judicial rule has developed for determining when a debt is incurred or owed by the debtor. The courts that directly address the issue often reach different conclusions based upon identical legal analyses and fact patterns that have no material distinctions.[10] Other courts ignore the issue completely, but reach the right result based on judicial fictions tailored to the facts or simple logic.[11] The threshold issue that must be

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[9] *See, e.g., Marley*, 62 F.3d at 106; *Upstairs Gallery*, 67 B.R. at 918; *Energy Cooperative*, 832 F.2d at 1001; *Makoroff v. Allegheny Graphics, Inc. (In re Allegheny Label, Inc.)*, 128 B.R. 947, 953 (Bankr. W.D. Pa. 1991); *Whittaker v. BancOhio Nat'l Bank (In re Lamons)*, 121 B.R. 748, 751 (Bankr. S.D. Ohio 1990); *Bob Grissett Golf Shoppes v. Confidence Golf Co. (In re Bob Grissett Golf Shoppes)*, 44 B.R. 156, 158 (Bankr. E.D. Va. 1984).

[10] *Compare, e.g., Upstairs Gallery* (in preference action to recover lease termination payment, debt incurred on date lease executed); *Martin v. BarclaysAmerican/Leasing, Inc. (In re Martin)*, 117 B.R. 243 (Bankr. N.D. Tex. 1990) (in preference action to avoid lien securing lease guaranty, debt incurred when lease executed); and *Bob Grissett Golf Shoppes* (in preference action to avoid payments made under settlement of breach of contract suit, debt arose when contract entered into between the parties) *with Marley* (in preference action to recover payments made in settlement of breach of employment contract/severance obligations, debt arose when contract breached); *Energy Cooperative* (in preference action to recover breach of contract damages, debt incurred when contract breached); *Durant's Rental Center, Inc. v. United Truck Leasing, Inc. (In re Durant's Rental Center, Inc.)*, 116 B.R. 362 (Bankr. D. Conn. 1990) (in preference action to recover settlement payments made after lease termination, debt incurred when lease was breached).

[11] *See, e.g., Brass Kettle Restaurants*, 790 F.2d at 576 (payment of contingent fee upon settlement of litigation not avoidable because law firm had equitable lien on unidentified future settlement proceeds as of the date the contingent fee agreement was signed); *Sunset Enters.*, 38 B.R. at 717 (court determined, with no analysis, that no antecedent debt for payment of equipment rentals because contract provided that obligation to make rental payments was contingent upon coal being mined); *Harman v. Sorlucco (In re Sorlucco)*, 68 B.R. 748, 752 (Bankr. D.N.H. 1986) (while a divorce

confronted is to determine the date upon which a contingent claim becomes a "debt" and whether the debt is "antecedent" and "owed" within the meaning of section 547. This issue has been addressed in other sections of the Bankruptcy Code,[12] and was resolved in cases dealing with former section 547(c)(2) of the Bankruptcy Code (the pre-1986 amendments "ordinary course of business" exception to preferences). *Nolden v. Van Dyke Seed Co. (In re Gold Coast Seed Co.)*, 751 F.2d 1118 (9th Cir. 1985) (debt not incurred on executory contract for delivery of seeds until seeds are delivered and debtor becomes liable to pay for the seeds); *Sandoz v. Fred Wilson Drilling Co. (In the Matter of Emerald Oil Co.)*, 695 F.2d 833 (5th Cir. 1983) (debt incurred when goods delivered or services provided under executory contract, not when invoice sent out); *Iowa Premium Serv. Co., Inc. v. First Nat'l Bank in St. Louis (In re Iowa Premium Serv. Co.)*, 695 F.2d 1109 (8th Cir. 1982) (*en banc*) (debt for interest payments on a note incurred when money used, not when note signed).[13]

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proceeding calls into existence various claims between the parties, no antecedent debt is created from such inchoate obligations until the decree is entered).

[12] Pursuant to 11 U.S.C. § 553, a creditor can offset a mutual prepetition debt it owes the debtor with the debt owed by the debtor. Therefore, courts must determine when such debts were incurred to insure they are mutual prepetition debts. *See United States Agricultural Stabilization and Conservation Serv. v. Gerth*, 991 F.2d 1428 (8th Cir. 1993) (in the setoff context, debt was incurred when contract was executed prepetition); *Sherman v. First City Bank of Dallas (In the Matter of United Sciences of America)*, 893 F.2d 720 (5th Cir. 1990) (debt incurred for setoff purposes when credit card reimbursement contract entered into prepetition and not when cardholders rescinded purchases postpetition and demanded refunds).

[13] While the Bankruptcy Amendments and Federal Judgeships Act of 1986 eliminated the section 547(c)(2) requirement that a debt be incurred within 45 days of payment in order to qualify for the "ordinary course of business" exception, the *Gold Coast Seed* and *Emerald Oil* cases, along with their Seventh Circuit counterpart, *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981), are still cited for the principle that a debt is not

Each of these courts went through the *exact* same debt/claim analysis as those deciding the issue under section 547(b)(2), yet reached conclusions which cannot be reconciled with those of the Fifth Circuit in the case at bar.

In the case at bar, the Fifth Circuit ruled that the assertion of even the most remote contingent claim created a debt owed by Southmark as of the date the claim was first asserted, even though the event that triggered liability on the claim, that is, the debt – the agreement of Southmark's board of directors to reimburse the Parks Group for costs incurred in waging a proxy contest – actually occurred simultaneously with the transfer.

While this conclusion is consistent with the Ninth Circuit's holding in *Upstairs Gallery,*[14] it is inconsistent with the

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incurred until the goods are delivered or the services are provided, and the debtor becomes legally obligated to pay for such goods and services. *See Marley*, 62 F.2d at 106; *Energy Cooperative*, 832 F.2d at 1001. *Barash* goes further and indicates that a debtor's obligation to pay first arises "whenever the debtor obtains a property interest in the consideration exchanged giving rise to the debt." *Barash*, 658 F.2d at 509. Petitioner does not know what consideration the Parks Group exchanged with Southmark that would have made Southmark liable for the Parks Group's proxy fight costs and expenses at the time the proxy contest and related litigation were commenced, and Southmark does not appear to allege that any such consideration existed.

[14] In *Upstairs Gallery*, the debtor entered into a five-year lease agreement with a shopping center. 167 B.R. at 916. Within ninety days of the debtor's bankruptcy, the landlord and the debtor entered into a termination agreement under which the debtor paid $38,000 to the landlord as a lease termination payment. *Id.* The Ninth Circuit correctly determined that a debt is incurred when a debtor first becomes obligated to pay it, but then determined that the debtor's debt for termination damages to the landlord arose not when the lease was terminated, but on the day the lease was signed, despite the fact that on that day, the landlord's claim for termination damages was wholly contingent upon the lease being terminated. 167 B.R. at 918. Therefore, the termination payment was made on account of an antecedent debt owed by the debtor before the payment was made and constituted a preference. *Id.*

two cases the Fifth Circuit ostensibly relied upon in deciding the case below: *Marley* and *Energy Cooperative*. In *Marley*, Southmark and Marley entered into an employment contract that required Southmark to pay severance benefits in the event Marley's employment was terminated. 62 F.3d at 105. Under the Bankruptcy Code's expansive definition of "claim," the execution of the contract gave rise to a contingent claim by Marley against Southmark for severance benefits. 11 U.S.C. § 101(5). Subsequently, Southmark terminated Marley and the parties entered into a settlement agreement, whereby Marley received a check for $400,000 and Southmark received a release of any further severance obligations to Marley. 62 F.3d 105. In its suit to recover the payment as a preference, Southmark alleged (consistent with *Upstairs Gallery*) that the payment was on account of an antecedent debt owed by Southmark before the payment was made because Southmark's debt to Marley was incurred when Marley executed his employment contract and the contingent claim for severance benefits arose. 62 F.3d 106.

Not so, held the Fifth Circuit panel that decided *Marley*. "Our focus, therefore, is on the date the debt was incurred and the date the transfer occurred. . . . *A debtor incurs a debt when he becomes legally obligated to pay it.*" 62 F.3d at 106 (*citing In re Emerald Oil Co.*) (emphasis added). Thus, although a contingent claim may have arisen when Marley's employment contract was executed, the debt was not incurred or **owed** by Southmark until Marley was terminated, which was the same date that Southmark became legally obligated to pay and, just happened to be, the same date the payment was made. *Id.* Thus, Southmark's severance payment to Marley was not a payment on account of an antecedent debt owed and was not a preference. *Id.*

The Fifth Circuit failed to recognize that the case at bar is analogous to *Marley*: same debtor, a contingent claim, the occurrence of the contingency, a settlement agreement and a payment pursuant to and simultaneous with the execution of the settlement agreement. Indeed, this case presents an even

more compelling situation for ruling that there was no "antecedent debt owed." In the case at bar, unlike Marley, the Parks Group did not have any contractual rights giving rise to its contingent claim. All that the Parks Group had was a statement in some pleadings and SEC filings indicating that they intended to seek to recover costs and attorneys' fees if they were successful in their proxy contest – that is, the Parks Group had a contingent hope of reimbursement of their attorneys' fees if they were successful in gaining control of the Southmark board.[15]

The Fifth Circuit primarily relied upon the Seventh Circuit's ruling in *Energy Cooperative*. Appendix, p. A-15. While the Seventh Circuit found a preference to exist in that case, a careful review of the facts of the case and the court's analysis shows that *Energy Cooperative* is consistent with *Marley* and *inconsistent* with the case at bar. In *Energy Cooperative*, the debtor ECI entered into a contract with SOCAP for the purchase of oil in January, 1981. 832 F.2d at 999. On March 11, 1981, ECI repudiated the contract. *Id.* On April 16, 1981, ECI and SOCAP settled and ECI paid SOCAP $1.6 million as compensation for ECI's breach of the contract.

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[15] *See generally* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES ¶ 11.01, p. 11-3 (1995) (stating that "the significant amount of money and time consumed by a proxy fight, and the *impossibility of recouping proxy fight costs if the insurgents failed to take control"* make it a less favorable method [than a tender offer] for obtaining control of a corporation) (emphasis added); *see also O'Neill v. Church's Fried Chicken, Inc.*, 910 F.2d 263, 265-66 (5th Cir. 1990) (describing the common law rule that allows shareholders to recover their attorneys' fees from the corporation *if they show they have conferred a substantial benefit* to the corporation as a result of their efforts). *O'Neill* was cited by the Fifth Circuit in its opinion (Appendix, p. A-4, n.4) which noted that *O'Neill* was a derivative action. It would seem that in a proxy contest, the only way to show substantial benefit is to succeed in taking over the company, thereby enabling the victor to request reimbursement from the new "friendly" board of directors.

Id. Subsequently, within ninety days of the settlement payment, ECI filed for bankruptcy. *Id.* The trustee sued SOCAP to recover the $1.6 million as a preference contending that "ECI had incurred a debt to SOCAP when it contracted to purchase the crude oil from SOCAP." 832 F.2d at 1001.

The Seventh Circuit conducted the same claim/debt analysis as the Fifth Circuit in the case at bar and in *Marley*, and as the Ninth Circuit did in *Upstairs Gallery*. However, the Seventh Circuit ultimately rejected the trustee's argument that ECI had incurred a debt to SOCAP when the contract was executed, that SOCAP had a contingent claim for breach of contract damages when the contract was executed, and that ECI's debt for breach of contract damages was incurred on that same date. *Id.* The Seventh Circuit concluded that such a holding would conflict with the law of at least two circuits, both of which had held that in contingent claim situations, the contingency had to occur before the debt was incurred or owed. *Id.*, *citing Gold Coast Seed Co.*, 751 F.2d at 1119 (buyer incurs debt at time goods are delivered, not at time buyer makes contract); *Iowa Premium*, 695 F.2d at 1111-12 (although creditor has contingent claim for future interest when note is signed, the debtor incurs debt for interest on note when funds are used and interest falls due, not when note is executed). The Seventh Circuit then proceeded to hold that the debt was owed by ECI on the date it repudiated the contract. 832 F.2d at 1002. This holding is consistent with that of the Fifth Circuit in *Marley*, but inconsistent with that of the Ninth Circuit in *Upstairs Gallery*. Note that because ECI repudiated the contract one month before it paid SOCAP, an antecedent debt was owed by ECI before the payment was made and the payment was preferential. *Id.* Had ECI paid SOCAP on the date it repudiated the contract, the result would have been the same as in *Marley* – no antecedent debt owed and no preference.[16]

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[16] A lower court case with a fact timetable identical to *Energy Cooperative* but a fact scenario more similar to the case at bar, in that the

The Fifth Circuit's decision in the case at bar and the Ninth Circuit's decision in *Upstairs Gallery* cannot be reconciled with the Fifth Circuit's decision in *Marley* and the Seventh Circuit's decision in *Energy Cooperative*.[17] Perhaps,

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relief requested in the litigation was primarily equitable, is *Murray v. Withrow (In re PM-II Assoc., Inc.)*, 100 B.R. 940 (Bankr. S.D. Ohio 1989). In *PM-II*, the debtor was charged on September 3, 1985 by the State of Ohio with having violated the Ohio Anti-Pyramid Sales Law. Subsequently, the lawsuit was terminated after a consent judgment was entered into that required PM-II to cease and desist violating the law, establish a restitution fund and pay certain civil penalties. On October 15, 1985, subsequent to the entry of the consent decree, PM-II paid the penalties and on December 10, 1985, PM-II filed for bankruptcy. The trustee sought to avoid the payment of the penalties as a preference. The Court analyzed the definition of "debt" and held that the payments to the State of Ohio were recoverable as a preference because the "liability was incurred at the time the consent judgment was agreed to, which was prior to payment [of the civil penalties] and was not a contemporaneous exchange. *Id.* at 944. *But see Imperial Corp. of America v. Milberg, Weiss, Bershad, Specthrie & Lerach (In re Imperial Corp. of America)*, 144 B.R. 115 (Bankr. S.D. Cal. 1992) (attorneys' fees paid out of settlement of class action suit for breach of securities law, RICO and the like could be recovered as preference because debt to class plaintiffs arose when suit filed).

[17] Other courts have also determined, directly or by implication, that in a contingent claim situation, a debt is not owed until the contingency that creates liability occurs. *Cybermech*, 13 F.3d at 822 (debt incurred under conditional sales agreement requiring partial payment upon acceptance of prototype when buyer made down payment; therefore, subsequent reimbursement of down payment after seller's repudiation was on account of antecedent debt owed); *Brass Kettle Restaurants*, 790 F.2d at 576 (although decision was based on an equitable lien received on the date the contingent fee agreement was signed, in effect, court determined that payment of a lawyer's contingency fee does not constitute a preferential transfer because the payment is made contemporaneously with settlement of the litigation, and the litigation must be settled before a debt is owed to the lawyer); *Sunset Enters.*, 38 B.R. at 717 (Fourth Circuit determined, with little analysis, that payment of equipment rentals was not preferential because contract provided that obligation to make rental payments was contingent upon coal being mined and, therefore, no antecedent debt owed

contingent claims arising from executory contracts are different from other types of contingent claims. This interpretation would reconcile *Marley*, which held that a party to an executory contract only has a "claim" against the debtor when the contract is breached or rejected, 62 F.2d at 106, with *Energy Cooperative*. 832 F.2d at 1002. It would not, however, explain *Upstairs Gallery* because a lease is the quintessential executory contract, yet the Ninth Circuit used the contract execution date, not its breach date, as the debt-triggering event.[18] 167 B.R. at 918.

More importantly, the statement regarding when a claim arises under an executory contract is just plain wrong.[19] As

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until coal was mined); *Newman v. Bank of New England Corp. (In re Bank of New England Corp.)*, 187 B.R. 405 (Bankr. D. Mass. 1995) (payment setting up severance escrow was not on account of an antecedent debt owed because finalization of employment agreement contingent upon specific severance terms being negotiated, despite fact that employee commenced employment nine months earlier under oral employment agreement with some severance package and, therefore, employment contract was simultaneous with establishment of escrow); *Southmark Corp. v. Bates, et al. (In re Southmark Corp.)*, No. 389-36324-SAF-11, Adv. No. 391-3415 (Bankr. N.D. Tex. Feb. 4, 1992, Felsenthal, J.) (contract gave defendants a contingent claim to a percentage of proceeds of asset sale, but no debt owed by Southmark until time of transfer because Southmark not legally obligated to pay defendants until sale of assets closed; therefore, payments made at closing not preferential); *Makoroff v. Allegheny Graphics, Inc. (In re Allegheny Label, Inc.)*, 128 B.R. 947, 953 (Bankr. W.D. Pa. 1991) (debt for payment of commission was not incurred until either buyer and seller were introduced or sale closed).

[18] While *Iowa Premium* involves a repealed statutory provision, the executory contract distinction would not explain the *Iowa Premium* decision, which follows the executory contract line of cases, because a promissory note is *not* an executory contract. 695 F.2d at 1111.

[19] The statement is based on pre-Bankruptcy Code law. Under the Act, contingent claims were expressly excluded from treatment in bankruptcy cases and holders of executory contracts did not have "provable" claims until the contract was rejected or breached. *See, e.g., Mohonk Realty Corp. v. Wise Shoe Stores, Inc.*, 111 F.2d 287, 290 (2d Cir. 1940), *cert. denied*, 311 U.S. 654 (1940). Unfortunately, despite the fact

this Court has repeatedly stated, the definition of claim is intentionally broad so as to encompass all possible obligations of the debtor. *Pennsylvania Dept. of Public Welfare*, 495 U.S. at 558. As recognized by the Seventh Circuit in *Energy Cooperative*, this definition clearly includes all types of contingent claims, including those arising from executory contracts. 832 F.2d at 1001-02. While executory contracts are given some separate treatment under the Bankruptcy Code, the act of assuming or rejecting the contract does not create the "claim" – it merely determines whether the ultimate claim is classified and treated as an administrative claim or a prepetition unsecured claim. *See* 11 U.S.C. § 365(g); *In re Greystone III Joint Venture*, 995 F.2d at 1281.

The Fifth Circuit's decision in the case at bar and the Ninth Circuit's decision in *Upstairs Gallery* cannot be reconciled with the Fifth Circuit's decision in *Marley*, the Seventh Circuit's decision in *Energy Cooperative* and the Eighth Circuit's decision in *Iowa Premium*. The lower courts have become so accustomed to using language indiscriminately that the definitions of claim and debt have become meaningless and section 547(b)(2) has become a statutory nullity.

II. The decision of the Fifth Circuit effectively renders one-half of section 547(b)(2) of the Bankruptcy Code meaningless, in complete disregard of the rules of statutory construction frequently enunciated by this Court.

As this Court has stated on many occasions, the task of resolving the dispute over the meaning of a statute begins

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that the Bankruptcy Code abolished the concept of "provable claims" and contingent claims are expressly intended to be treated in bankruptcy cases (H.R. REP. No. 95-595, at 309 (1977)), many courts anachronistically still recite the old holdings to support construction of the Bankruptcy Code. *See Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1281 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992).

with the language of the statute itself. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985). Section 547(b)(2) clearly requires that three questions be answered: (1) Was there a *debt*? (2) If there was a debt, was it an *antecedent debt*? and (3) Was the debt *owed* by Southmark prior to the transfer?[20] If the answer to any one of these questions is no, the transfer was not a preference.

In this case, however, the Fifth Circuit limited its analysis to determining whether or not a *claim* existed. Once the Fifth Circuit concluded that a claim, albeit a contingent one, existed, it decided that all other elements of section 547(b)(2) were satisfied – effectively rewriting section 547(b)(2) beyond even its pre-Code language, as if it read "for or on account of a claim," in complete disregard of both the statute and its legislative history. It summarily dismissed Petitioner's arguments:

> (i) that Congress's use of the word "liability" in the definition of "debt" meant that while claim and debt might be coextensive, they were not always synonymous,
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> (ii) that a "claim" and a "debt" do not necessarily arise at the same point in time, and
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> (iii) that the language of section 547(b)(2) itself required not only that an "antecedent debt" exist, but that it be "owed" as well.

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[20] *See In re Brennan*, 187 B.R. 135, 153 (Bankr. D.N.J. 1995) ("To satisfy section 547(b)(2), however, a debt must be *both* 'antecedent' *and* 'owed by the debtor before such transfer was made'. . . . Under general principles of statutory construction, courts are to attempt to give meaning to all statutory language and to avoid determinations which render any statutory language a nullity. . . . [C]ourts should construe the clause 'owed by the debtor before the transfer was made' in section 547(b)(2) as adding some meaning to the prior words 'antecedent debt'.") (emphasis in original).

The Fifth Circuit's construction of section 547(b)(2) is in direct contravention of established Supreme Court law on statutory construction and the construction of the Bankruptcy Code. *Pennsylvania Dept. of Public Welfare*, 495 U.S. at 562 ("Our cases express a deep reluctance to interpret a statutory provision so as to render superfluous other provisions in the same enactment"). The Fifth Circuit should not be permitted to ignore the plain meaning of section 547(b)(2) by using the mantra of *stare decisis* to misconstrue Supreme Court case law, as well as case law in other circuits.

A. Not every claim constitutes a debt.

For most courts, the initial focus in connection with an analysis of section 547(b)(2) is on the definition of the word "debt." "Debt" is defined in the Bankruptcy Code as "liability on a claim." 11 U.S.C. § 101(12); *see also Marley*, 62 F.3d at 106; *Upstairs Gallery, Inc.*, 167 B.R. at 917; *Cybermech*, 13 F.3d at 822; *Energy Cooperative*, 832 F.2d at 1001; *Emerald Oil*, 695 F.2d at 837.

The courts then proceed to analyze the word "claim." "Claim" is defined broadly as a "right to payment" – whether that right is "reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5); *see also Marley*, 62 F.3d at 106; *Upstairs Gallery, Inc.*, 167 B.R. at 917; *Cybermech*, 13 F.3d at 822; *Energy Cooperative*, 832 F.2d at 1001; *Emerald Oil*, 695 F.2d at 837. Based on this analysis, and the legislative history of section 101(12), as well as on the 1990 decision of the Supreme Court in *Pennsylvania Dep't of Public Welfare*, the courts then uniformly conclude that "claim" and "debt" are "coextensive."

This is where the problem arises. Section 547 does not provide that any person who receives payment on a claim has received a preference. Congress defined the word "claim" in the Bankruptcy Code and used it in various sections where it intended it to be applicable. Claim is defined broadly because in some instances, such as discharge, policy dictates that all

that is needed is a claim – some small assertion of even the most remote obligation on the part of the debtor to the claimant. However, in other circumstances, policy dictates that there be more than a claim – that there be a debt, *i.e.*, ***liability*** on a claim.[21] For example, under section 303 of the Bankruptcy Code, a person cannot have a claim "contingent as to **liability**" and be eligible to file an involuntary petition. In other words, one must have a debt, rather than just a claim, in order to throw someone involuntarily into bankruptcy.

The statement that debt and claim are coextensive comes from the legislative history of section 101(12), defining "debt." H.R. REP. NO. 95-595, at 310 (1977); S. REP. NO. 95-989, at 23 (1978). Because the definition of "debt" is "*liability* on a claim," there is no question that *once a debt comes into existence*, debt and claim are coextensive. If Bubba owes a debt to Betty Jo (*i.e.*, is liable to Betty Jo), then Betty Jo has a claim against Bubba. The reverse is not always true. The fact that the definition of debt utilizes the word "claim" and adds a modifier – "liability" – makes it self evident that the concept of debt is intended to be less broad than the concept of claim. They are not always mirror images of each other. Quite simply, the literal definition of "debt" requires the existence of *both* (i) a "claim," as that term is defined in the Bankruptcy Code and (ii) "liability" on that claim.[22] To hold otherwise is to disregard the specific words

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[21] Petitioner will be the first to admit that the Bankruptcy Code is not a model of clarity or consistency in this regard. Both claim and debt are used hundreds of times in the Code and, oftentimes, they appear to be used interchangeably or without thought. But the need to limit certain rights and privileges under the Bankruptcy Code to debts rather than mere claims does exist.

[22] *But see New York Credit Adjustment Bureau, Inc. v. Just In-Materials Designs, Ltd. (In re Vasu Fabrics, Inc.)*, 39 B.R. 513, 517 (Bankr. S.D.N.Y. 1984) ("liability" has just as broad a definition as "claim" and encompasses contingent liabilities).

chosen by Congress. The Bankruptcy Code contains two different definitions for "claim" and "debt." The term "debt" is limited to those claims where liability has been incurred.

This analysis does not conflict with Supreme Court case law stating that debt and claim are coextensive. In many instances, if Betty Jo has a claim against Bubba, then Bubba owes a debt to Betty Jo. However, this is not always the case. If Bubba contracts to buy widgets from Betty Jo for delivery at some date in the future, at any point in time prior to delivery of the widgets, Betty Jo has a claim against Bubba for the price of the widgets contingent upon her delivery of the widgets and Bubba has a contingent claim against Betty Jo for the widgets or for damages if Betty Jo fails to deliver the widgets. However, during this interim period, Bubba does not yet owe a debt to Betty Jo and Betty Jo does not yet owe a debt to Bubba. A debt requires liability, and it is incurred only when the debtor becomes legally obligated to pay it.[23] If a debt has not been "incurred," liability has not been created.

It is within this gap period between claim and debt that contingent claims fall. A contingent claim is:

> [O]ne which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event which will trigger the liability of the debtor to the alleged creditor and if such triggering event or occurrence was one reasonably contemplated by the debtor and creditor at the time the event giving rise to the claim occurred.
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> Thus, in the case of the classic contingent liability of a guarantor of a promissory note executed

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[23] *See, e.g., In re Emerald Oil Co.*, 695 F.2d at 836-37 (debt is legally incurred when services are provided, not when invoice is presented); *Marley*, 62 F.3d at 106 (debtor incurs a debt when it becomes obligated to pay it); *Energy Cooperative, Inc.*, 832 F.2d at 1001 (same); *Gold Coast Seed Co.*, 751 F.2d at 1119 (debt incurred when goods are delivered and debtor becomes obligated to pay for goods); *In re United Sciences of America*, 893 F.2d at 724 (in set off context, bank incurred debt when right to payment arose, not when bank asserted right).

> by a third party, both the creditor and the guarantor knew there would be liability *only if* the principal maker defaulted. *No obligation arises until such default.*

In re All Media Properties, Inc., 5 B.R. 126, 133 (Bankr. S.D. Tex. 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981) (*per curiam*) (emphasis added). The fact that the filing of a bankruptcy triggers the policy of treating every possible contingent claim in some manner in the bankruptcy case does not support making every claim a debt. Some claims are contingent and only become debts when the contingency occurs (the debt is incurred).

In this case, the Fifth Circuit found that the statements of the Parks Group regarding their intent to seek to recoup their proxy fight costs and expenses constituted a claim. Assuming this is true, Southmark still had no *liability* on any claim asserted by the Parks Group until Southmark's board of directors agreed to incur such obligation, which happened when the Settlement Agreement was executed and the $3.3 million transfer was made. The proxy solicitation materials filed by the Parks Group with the SEC indicated only that the Parks Group intended to seek reimbursement of the proxy related fees and expenses *to the extent allowed by law*. The estimation of the dollar amount of those fees was included in the proxy solicitation materials because the SEC required such disclosure. Rule 14a-11 and Schedule 14(b), Securities Exchange Act of 1934, 15 U.S.C. § 77b, *et seq.* The costs and attorneys' fees relating to the proxy contest would only have been recoverable *if* the proxy contest had been successful *and* Southmark's board had then authorized their recovery. No liability existed and no consideration was exchanged based solely upon the Parks Group's statement of their intent to seek reimbursement of these expenses.

Nor do the boilerplate requests for recovery of attorneys' fees and expenses in the prayers of a few of the lawsuits constitute a debt of Southmark. These requests were included in the prayers because such requests are generally included in prayers for relief, just as they were included by Southmark in

its prayers for relief in the defensive lawsuits it filed. The requests contained in the lawsuits were only with regard to the attorneys' fees and expenses incurred in the lawsuits themselves, not those fees and expenses associated with the proxy contest. Southmark would *only* have incurred liability to pay these litigation-related fees and expenses if a court, in its discretion, and after an evidentiary hearing, ordered Southmark to do so after finding that the Parks Group had conferred a benefit on Southmark.[24]

In this case, no debt was incurred by Southmark on the contingent claim of the Parks Group in either the proxy contest or the related lawsuits for reimbursement of costs and expenses because Southmark had no *liability* on such claim. If such liability had existed, Southmark presumably would have booked such liability on its balance sheet. Reimbursement of fees and expenses was at all times contingent upon either an order of a court or the consent of the Southmark board of directors. That contingency occurred when Southmark executed the Settlement Agreement, and the transfer Southmark is seeking to avoid was made simultaneously with the occurrence of the contingency. There was no liability on the claim and, thus, no debt until the execution of the Settlement Agreement.

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[24] *See, e.g., O'Neill*, 910 F.2d at 265 (shareholders who pursue successful derivative suit may recover their attorneys' fees upon a showing that they conferred a substantial benefit to corporation); *Barton v. Drummond Co.*, 636 F.2d 978 (5th Cir. 1981) (court remanded for *evidentiary hearing* on whether class action plaintiffs' results were *sufficient* to allow them to recover attorneys' fees); *National Home Products, Inc. v. Gray*, 416 F. Supp. 1293 (D. Del. 1976) (court ordered corporation to pay proxy expenses incurred in connection with court-ordered board meeting after proxy litigants had been successful). In each of these cases, the debt owed by the corporate defendant to the plaintiff for reimbursement of the plaintiff's fees and expenses was contingent upon an order of the court finding for the plaintiff, not only on the corporate issues, but on the benefit of such substantive victory to the corporate entity.

B. Even if a debt existed, the debt had to be "antecedent" and "owed" by Southmark consistent with the plain meaning of section 547(b)(2) of the Bankruptcy Code.

Even if this Court concludes that "claim" and "debt" are synonymous, section 547(b)(2) requires that a debt be both "antecedent" and "owed" to constitute a preferential transfer. Consequently, one must compare when the debt was incurred with when the debt was paid. *See, e.g., Marley*, 62 F.3d at 106. The question before this Court is whether a debt is incurred or owed from the moment a contingent claim is asserted or whether it is the occurrence of the contingency that gives rise to a debt being owed.

Courts are required to consider that Congress intended to use the words it used in writing a statute. *Ron Pair Enters.*, 489 U.S. at 242. Section 547(b)(2) is unambiguous, and must be enforced according to its terms. Section 547(b)(2) specifically states that the payment must be on "account of an *antecedent debt owed by the debtor* before such transfer was made." 11 U.S.C. § 547(b)(2) (emphasis added). The phrase "antecedent debt" contained in section 547(b)(2) is amplified by the phrase "owed by the debtor before such transfer was made." According to Black's Law Dictionary, the word "owe" means "to be bound to do or omit something, especially to pay a debt." BLACK'S LAW DICTIONARY 1005 (6th ed. 1990). A debt does not become "owed" until the debtor becomes bound to pay, and logic dictates that a debt cannot be owed before it is incurred. Therefore, regardless of whether the assertions of the Parks Group amounted to a "claim" or a "debt," Southmark had no liability – contractual or otherwise – to reimburse the Parks Group for their proxy contest fees and expenses and, therefore, the debt was not "owed" until a court determined that Southmark was legally required to reimburse the Parks Group or until the parties contractually agreed that Southmark would do so. Therefore, to the extent there was a "debt," it was not antecedent or owed.

The Fifth Circuit ignored the phrase "owed by the debtor before such transfer was made," as if it had no meaning or purpose. This is fundamentally contrary to the rules of statutory construction. Congress rewrote the preference provision of the Bankruptcy Code in 1978. *Union Bank v. Wolas*, 502 U.S. 151, 160-61 (1991). The "reasonable cause to believe" the debtor was insolvent requirement was eliminated, a presumption of insolvency during the ninety days preceding the petition date and new exceptions were created, and the antecedent debt requirement was clarified and further limited. *Compare* Bankruptcy Act § 60 (former 11 U.S.C. § 96) *with* 11 U.S.C. §§ 547(b), (c)(2) & (f); *see also* H.R. REP. NO. 95-595, at 177-79, 372-75 (1977); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PTS. I AND II, H.R. DOC. NO. 93-137, at 201-11 (1973) (the "1973 COMMISSION REPORT").

Under the Bankruptcy Act, a transfer needed only to be "for or on account of an antecedent debt, made or suffered by such debtor while insolvent" to constitute a preference. 11 U.S.C. § 96(a) (repealed). The Bankruptcy Review Commission recognized the problems with this phrase and even recommended that the words "antecedent debt" be defined.

> Another difficulty with the present Act is that, although a preference is defined as a transfer in whole or partial satisfaction or securing of an "antecedent debt," there is no guidance to when a debt is "antecedent." . . . The Commission recommends that the potential harshness and uncertainty be eliminated by defining "antecedent debt" as a debt incurred more than five days before a transfer paying or securing the debt. . . . The Commission also recommends that "antecedent debt" be defined so as to exclude certain debts the payment of which do not infringe substantially on the goals of the preference provisions.

1973 COMMISSION REPORT, at 205.

The House Judiciary Committee agreed with the Bankruptcy Review Commission that the preference section of the

Bankruptcy Act was "hopelessly complex." REPORT OF THE COMMITTEE ON THE JUDICIARY, HOUSE OF REPRESENTATIVES, to accompany H.R. 8200 at 178, (1977) (the "JUDICIARY COMMITTEE REPORT"). The draft of the proposed revision to section 60 of the Act contained in the JUDICIARY COMMITTEE REPORT provided as follows:

> § 60a(1). A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by or perfected against such debtor [while insolvent]. . . .

JUDICIARY COMMITTEE REPORT, at 210.

This draft, however, did not solve the antecedent debt definitional problem pointed out by the Bankruptcy Review Commission. Subsequently, the ultimate drafters of the new Bankruptcy Code appear to have found defining antecedent debt to be too cumbersome. Because it was decided that the new preference statute would contain a presumption of insolvency, the "made or suffered by the debtor while insolvent" clause was removed. In its place, after "antecedent debt," the requirement that the antecedent debt be "*owed by the debtor before such transfer was made*" was added to the statute. This addition to the statute resolved the Bankruptcy Review Commission's concerns regarding the confusion over what was an "antecedent debt." An "antecedent debt" has to be **"owed by the debtor" before** it is paid.

A person cannot owe a debt before it is incurred. *See* 4 COLLIER ON BANKRUPTCY ¶ 547.05, at 547-39 (15th ed. 1996) ("Although 'antecedent debt' is not defined by the Code, essentially a debt is 'antecedent' if it is *incurred* before the transfer.") (*citing Gold Coast Seed Co.*). Therefore, even if the definition of "debt" encompasses contingent liabilities, the requirement that an antecedent debt be owed before it is paid eliminates the contingency issues because a debt, even a contingent one, *cannot be owed* until the contingency occurs.

This is exactly the holding of *Marley*, 62 F.3d at 106. *Certainly, if Southmark did not "owe" anything to Marley – a party with an employment contract and contractual rights – prior to termination and execution of the settlement agreement, then it did not "owe" anything to the Parks Group prior to the Parks Group obtaining either a court order finding substantial benefit or, as happened, the consent of Southmark's board of directors to reimburse the Parks Group's fees and expenses as set forth in the Settlement Agreement.* In the case at bar, even assuming the broadest definitions of claim and debt (*i.e.*, assuming the terms are essentially synonymous and encompass contingent obligations), Southmark was not *legally obligated* to reimburse the Parks Group for the Parks Group's fees and expenses – *i.e.*, Southmark did not "owe" or "incur" this debt – until the Parks Group was successful in the proxy contest (upon the execution of the Settlement Agreement). Therefore, no antecedent debt was *owed* by Southmark at the time the $3.3 million transfer was made.

Through its holding in this case, the Fifth Circuit has, in effect, returned the preference statute to its pre-Code language, recreating the very problems Congress sought to eliminate in 1978. In contingent claim situations, in order for a debtor to **owe** a debt, the contingency must occur. In the preference context, if the contingency occurs on the same date payment is made, the debt is not antecedent and its payment is not a preference. If the contingency occurs prior to the date of payment, a preference is received. Congress (and its minions) worked long and hard on the revised preference provision contained in the Bankruptcy Code. A writ is needed in this case to insure that section 547(b)(2) is consistently applied, as written, in its entirety by every court in every circuit.

CONCLUSION

The issue of whether a contingent claim constitutes an "antecedent debt owed" prior to the occurrence of the contingency is an important one. Not only is the recovery of preferences a significant fundamental policy of the Bankruptcy

Code, but the possibility of the recovery of certain payments in the event of a future bankruptcy affects the commercial practices of all creditors in their prepetition dealings with a potential debtor. While the facts of this case may be unusual, every bankruptcy case involves contingent claims of some sort and every bankruptcy case involves potential preference litigation. A writ of *certiorari* is necessary in this case to insure that section 547(b)(2) is consistently and uniformly applied as written.

Respectfully submitted,

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IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 95-10872

IN THE MATTER OF: SOUTHMARK CORPORATION

Debtor

SOUTHMARK CORPORATION

Appellant,

versus

SCHULTE ROTH & ZABEL

Appellee.

(Filed July 2, 1996)

Appeal from the United States District Court
for the Northern District of Texas

Before POLITZ, Chief Judge, and WIENER and BARKSDALE, Circuit Judges.

WIENER, Circuit Judge:

In a settlement agreement entered into prior to filing for bankruptcy, Southmark agreed to reimburse a group of dissatisfied, minority-interest shareholders for expenses incurred in connection with their proxy contest and related lawsuits. Southmark now appeals the bankruptcy court's ruling that this transfer was not "for or on account of an antecedent debt owed by the debtor before such transfer was made" and thus not a preferential transfer under 11 U.S.C. § 547. Southmark also appeals

the bankruptcy court's denial of its leave to file a second amended complaint. Finding reversible error in the bankruptcy court's determination that attorneys' fees and costs were not antecedent debts, we reverse and remand.

I.

FACTS AND PROCEEDINGS

This bankruptcy case has its roots in a proxy contest waged by a group of dissatisfied, minority-interest shareholders of Southmark known as the Parks Group. The Parks Group comprised Defendants-Appellees R&P Ventures ("R&P") and Garson L. Rice, Sr., as well as former defendants Herbert B. Parks and Byron Investments, Inc. ("Byron").[1] Defendant-Appellee Schulte Roth & Zabel ("SR&Z") is a law firm, which was retained to represent the Parks Group.[2]

In March 1989, the Parks Group disclosed to the Securities and Exchange Commission ("SEC") an intention to propose nominees for election to Southmark's board of directors. In April, the group publicly announced its intention to wage a proxy contest for control of Southmark. Soon thereafter the Parks group disseminated several statements in opposition to the then-current board of directors, expressing dissatisfaction with a number of matters, such as corporate governance and

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[1] These two former defendants were non-suited after each filed for bankruptcy.

[2] Prior to our hearing oral argument in this appeal, Southmark settled with R&P and Rice, leaving SR&Z as the only defendant.

executive compensation. In these solicitation materials, the Parks Group also indicated that, to the extent legally permissible, it intended to seek reimbursement of the costs and expenses incurred in connection with the proxy contest.

Between February and May 1989, the Parks Group initiated three actions in state and federal courts in connection with the proxy contest, and Southmark initiated two actions in state and federal courts (collectively, the Lawsuits). Through its claims and counterclaims in the Lawsuits, the Parks Group sought (1) equitable and injunctive relief which included the right to examine Southmark's record of shareholders, and (2) judgments (a) blocking the implementation of, and declaring null and void, a Southmark anti-takeover "poison pill" provision, (b) prohibiting the Southmark directors from soliciting proxies unless specified disclosures were made, (c) directing the Southmark directors to cure deficiencies in their proxy statement, and (d) forcing Southmark and its directors to refrain from postponing a scheduled shareholders' meeting.[3] In two of its actions as plaintiff and in one of its counterclaims as defendant, the Parks Group requested that it be awarded costs and disbursements,

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[3] In one of its actions, the Parks Group also sought monetary damages in connection with a threatened cancellation of a scheduled shareholders' meeting. This monetary relief was sought only against the Southmark directors personally, however, not against Southmark. Southmark's by-laws provide that its directors are to be indemnified to the extent permissible under Georgia law.

including reasonable attorneys' fees, incurred in these Lawsuits.[4]

On May 24, 1989, a comprehensive settlement agreement ("Agreement") was reached with respect to the proxy contest and all of its sub-plots. In addition to, among other things, ending the proxy contest and the Lawsuits and giving the Parks Group a voice on the Southmark board of directors, the Agreement also required Southmark to reimburse the Parks Group for all expenses, including the attorneys' fees, incurred in connection with the proxy contest and the Lawsuits. The parties estimated these expenses to be $3.3 million.

At 1:00 p.m. on that same day – approximately four hours before the Agreement was formally executed – Southmark transferred the $3.3 million to SR&Z by wire. In this instance, SR&Z was acting essentially as an escrow agent. It was under instructions to return these funds to Southmark in the event that the Agreement did not get executed. But the Agreement was formally executed by about 5:00 p.m. that day, so the following morning SR&Z transferred all of these funds to R&P by wire. R&P in turn transferred almost all of the money to Byron, who, later

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[4] *See O'Neill v. Church's Fried Chicken, Inc.*, 910 F.2d 263, 265-66 (5th Cir. 1990) (describing the common law rule that allows shareholders to recover their attorneys' fees from the corporation if they show that they have conferred a substantial benefit to the corporation as a result of their efforts). This case, however, was a stockholder's derivative action; the instant case is not.

that same day, issued a check payable to SR&Z for $1 million.[5]

On July 14, 1989 – less than 90 days after the $3.3 million transfer, and thus within the preferential transfer window – Southmark filed for bankruptcy under Chapter 11. Southmark's plan of reorganization became effective on August 10, 1990. It specifies, inter alia, that reorganized Southmark is the representative of the Chapter 11 bankruptcy estate for purposes of pursuing causes of action, such as the instant one, under the bankruptcy code

On June 19, 1991, Southmark filed the original complaint in the action underlying this appeal. The members of the Parks Group were made defendants, and Southmark sought, among other things, recovery of the $3.3 million transfer as a preference under 11 U.S.C. § 547. A first amended complaint was filed on July 12, 1991.

Approximately one month later, on August 19, 1991, Rice and R&P filed their answers, denying that the transfers were preferences and asserting affirmative defenses under § 547(c). To pursue settlement, however, SR&Z obtained from Southmark several extensions of time within which to file its answer. As a result, eight additional months passed before SR&Z filed its answer on April 21, 1992.

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[5] As the district court found no preference, the amount that Southmark actually could recover from SR&Z alone, assuming that the $3.3 million transfer is a preference, is not at issue in this appeal.

On June 16, 1992, Southmark filed a motion for leave to file a second amended complaint for the purpose of making five amendments, three of which are now moot. The two amendments that are not moot sought (1) to identify the Southmark directors, sued for money damages by the Parks Group as creditors of Southmark, for whose benefit the preferential transfers were made; and (2) to add an alternative basis for recovery of the $3.3 million, i.e., that it was a *fraudulent* transfer under 11 U.S.C. § 548. Following oral argument on this motion, the bankruptcy court denied Southmark leave to amend its complaint.

Later, in April 1993, the bankruptcy court ruled on both Southmark's and the Parks Group's motions for summary judgment with respect to the preferential transfer issue. In its order, the bankruptcy court granted in part Southmark's motion for summary judgment with respect to many of the required elements under § 547. Ultimately, however, the bankruptcy court ruled in favor of the Parks Group, concluding that the $3.3 million transfer of the settlement funds was not "made for or on account of an antecedent debt owed by the debtor before such transfer was made" as required under § 547(b)(2), and thus was not a preferential transfer.

The district court affirmed both the bankruptcy court's denial of Southmark's motion for leave to amend its complaint and that court's ruling that the $3.3 million was not recoverable as a preference. Southmark now appeals both of these issues to us.

II.
ANALYSIS

A. Standard of Review

We review a bankruptcy court's denial of a motion for leave to amend a complaint under an abuse of discretion standard.[6] We review a bankruptcy court's grant of summary judgment de novo.[7] All fact questions are viewed in the light most favorable to the non-movant. Summary judgment is proper when no issue of material fact exists and the moving party is entitled to judgment as a matter of law.[8]

B. Denial of Motion for Leave to Amend Complaint

Federal Rule of Civil Procedure 15(a) provides that leave to amend pleadings "shall be freely given when justice so requires." Although Rule 15 "evinces a bias in favor of granting leave to amend,"[9] it is not automatic.[10] A decision to grant leave is within the discretion of the trial court[11] Its discretion, however, is not broad enough to permit denial if the court lacks a substantial reason to do so.[12] In deciding whether to grant such leave, the

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[6] *Wimm v. Jack Eckerd Corp.*, 3 F.3d 137, 139 (5th Cir. 1993).

[7] *In re Omni Video, Inc.*, 60 F.3d 230, 231 (5th Cir. 1995).

[8] *Id.*; Fed. R. Civ. P. 56(c).

[9] *Dussouy v. Gulf Coast Inv. Corp.*, 660 F.2d 594, 598 (5th Cir. 1981).

[10] *Wimm v. Jack Eckerd Corp.*, 3 F.3d 137, 139 (5th Cir. 1993).

[11] *Louisiana v. Litton Mortgage Co.*, 50 F.2d 1298, 1302-03 (5th Cir. 1995).

[12] *Id.*

court may consider such factors as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party, and futility of amendment[13]

The reasons stated by the bankruptcy court for denying Southmark's leave to amend its complaint were unreasonable delay and prejudice. Specifically, the bankruptcy court concluded that the transactions on which the proposed amendments were based were known to Southmark both at the time its plan was confirmed and at the time its original and first amended complaints were filed. The bankruptcy court also noted that before filing its original complaint, Southmark had the benefit of an Examiner's Report which analyzed causes of actions that Southmark may possibly have, including this one. Further, the bankruptcy court concluded that the fact that Southmark's bankruptcy is large and complicated does not justify delay.

Finally, the bankruptcy court determined that prejudice would result to R&P and Rice[14] from the addition of a fraudulent transfer claim under 11 U.S.C. § 548, as these two defendants had stipulated to Southmark's insolvency with respect to the § 547 preference claim. Although the debtor's insolvency at the time of transfer is an element of both § 547 and § 548, § 547 (g) contains a presumption

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[13] *Foman v. Davis*, 371 U.S. 178, 182, 83 S. Ct. 227, 230, 9 L.Ed.2d 222 (1962); *Wimm v. Jack Eckerd Corp.* 3 F.3d 137, 139 (5th Cir. 1993).

[14] Recall that prior to our hearing oral argument in this appeal, Southmark settled with R&P and Rice.

of insolvency whereas § 548 does not. The bankruptcy court did not find that prejudice would result with respect to any of the other amendments sought to be made by Southmark.

The district court concluded that the reasons articulated by the bankruptcy court were sufficient and affirmed the denial of leave to amend.

In arguing that the bankruptcy court abused its discretion in denying leave to amend its complaint for a second time, Southmark contends that delay alone – as distinguished from "undue" delay – cannot justify this denial.[15] Southmark further argues that its knowledge of the transactions underlying the amendments prior to the time that the adversary proceeding was commenced is an insufficient basis for denying leave to amend.[16] The delay in this case was not "undue," insists Southmar, because at the time the Motion to Amend was filed, (1) no trial date had been set, (2) the only party that had commenced discovery was Southmark, (3) SR&Z had filed its answer only about two months earlier, in April, 1992, following a nine month "hiatus" during which the parties discussed settlement, and (4) no dispositive motions had been filed by any party. Southmark thus argues that the instant case

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[15] *See Dussouy v. Gulf Coast Inv. Corp.*, 660 F.2d 594, 599 (5th Cir. 1981).

[16] *See Carson v. Polley*, 689 F.2d 562, 584 (5th Cir. 1982) ("A litigant's failure to assert a claim as soon as he could have is properly a factor to be considered in deciding whether to grant leave to amend. Merely because a claim was not presented as promptly as possible, however, does not vest the district court with authority to punish to litigant.").

is distinguishable from a number of other cases in which the denial of leave to amend a complaint has been affirmed, noting that those other cases involved attempts to amend closer to the eve of trial or after dispositive motions had been filed.[17]

We are unpersuaded by Southmark's arguments. That many cases in which a denial of leave to amend a complaint has been affirmed involved proposed amendments closer to the eve of trial does not preclude a district court from properly exercising its discretion to deny leave to amend under particular facts like those present in the instant case. "Liberality in pleading does not bestow on a litigant the privilege of neglecting her case for a long period of time."[18] Accordingly, we have indicated that, in exercising its discretion to deny leave to amend a complaint, a trial court may properly consider (1) an "unexplained delay" following an original complaint,[19] and (2) whether the facts underlying the amended complaint were known to the party when the original complaint was filed.[20]

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[17] *E.g., Daves v. Payless Cashways, Inc.*, 661 F.2d 1022, 1025 (5th Cir. 1981) (affirming the district court's denial of leave to amend a complaint when that amendment was filed "on the eve of trial after discovery").

[18] *Id.* (discussing a motion for leave to amend a complaint under Rule 15(a)).

[19] *Id.*

[20] *Layfield v Bill Heard Chevrolet Co.*, 607 F.2d 1097, 1098 (5th Cir. 1979), *cert. denied*, 446 U.S. 939, 100 S.Ct. 2161, 64 L.Ed.2d 793 (1980).

In the instant case, Southmark sought leave to add both a fact of which it had been aware since before it filed its original complaint and a cause of action based on the identical, known facts that underlie its original complaint. This motion for leave to amend was filed approximately (1) thirty-eight months after the transfer at issue was made; (2) twenty-four months after the Examiner's Report was filed, describing the details and legal implications of this transfer; (3) thirteen months after the original complaint was filed; and (4) eleven months after the first amended complaint was found. Moreover, Southmark offers no reasonable explanation for its delay in amending its complaint.

After reviewing the record in this case, we cannot fault the bankruptcy court's discretionary determination that allowing Southmark to amend its complaint would not further the purposes of Rule 15, but to the contrary would serve only to reward Southmark for its unreasonable delay. Accordingly, we conclude that the district court did not abuse its discretion in denying Southmark's motion for leave to amend its complaint.

C. Preferential Transfer

Southmark bears the burden of proving that the $3.3 million transfer in question is avoidable as a preference.[21] The element contested in this appeal is whether under § 547(b)(2) the transfer was "for or on account of an antecedent debt owed by the debtor before such transfer

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[21] 11 U.S.C. § 547(g).

was made.[22] A debt is antecedent if it is incurred *before* the transfer.[23] Thus, this issue turns on whether, for purposes of the bankruptcy code, the Parks Group's demand for costs and attorneys' fees incurred in connection with its challenges to the corporate governance of Southmark constituted a "debt" prior to the execution of the Agreement. If it did, the debt would be antecedent; but if it only became a debt contemporaneously with the execution of the Agreement, it would not be antecedent.

The bankruptcy code defines the term "debt" as "liabilty on a claim."[24] The term "claim" is broadly defined in § 101(5) as a:

> (A) Right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or
>
> (B) Right to an equitable remedy for breach of performance if such breach gives rise to a right to payment whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

The bankruptcy court here held that, unlike the claim for equitable relief itself, the Parks Group's affiliated request for costs and attorneys' fees was a "claim"

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[22] 11 U.S.C. § 547(b)(2).

[23] *Southmark Corp. v. Marley*, 62 F.3d 104, 106 (5th Cir. 1995), *cert denied*, ___ U.S. ___, 116 S. Ct. 815, 133 L.Ed.2d 760 (1996).

[24] 11 U.S.C. § 101(12).

because it did give rise to a right to payment in connection with the equitable relief requested. The bankruptcy court went on to hold, however, that these litigation demands were not a "debt" – even though the court acknowledged that in bankruptcy the terms "claim" and "debt" are usually synonymous.

The court reasoned that "[h]ad Southmark taken the corporate action sought by the Parks Group in the proxy contest and related Lawsuits, Southmark would have had no liability to the Parks Group for the payment of any costs and attorneys' fees. Therefore, in this case, no right to payment came into play and no debt was owed by Southmark to the Parks Group until the proxy contest and related Lawsuits were settled in accordance with the terms of the Settlement Agreement." Therefore, concluded the court, as the transfer in question was made prior to, or at least concurrently with, the Agreement's execution, the transfer was not made on account of an antecedent debt. The district court affirmed this holding on essentially the same reasoning, adding that the Parks Group could not have filed a suit for these costs and fees alone, but rather they were ancillary to the request for injunctive relief.

Southmark insists that the courts below erred in determining that there was no "debt" prior to the execution of the Agreement. We agree.

We note that at the outset that we are in agreement with the bankruptcy court's conclusion that, prior to the execution of the Agreement, the Parks Group's demand for costs and attorneys' fees did constitute a "claim" for purposes of the bankruptcy code. Although the right to

payment of these expenditures may have been disputed and even contingent, such a right is nevertheless encompassed by the expansive statutory definition of the term "claim." This conclusion also comports with the legislative history of the statute. The House and Senate Reports state that "[b]y this broadest possible definition [of the term 'claim'] . . . the bill contemplates that all legal obligations of the debtor, *no matter how remote or contingent*, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court."[25] Thus, like the bankruptcy court, we conclude that, prior to the execution of the Agreement, the Parks Group's amicable and judicial demands for costs and attorneys' fees were "claims" within the intendment of the bankruptcy code.[26] On the other hand, we cannot agree with the bankruptcy court's conclusion that this "claim" was not a "debt." Instead, we conclude that the claim is also a debt.

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[25] H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6266 (emphasis added); S. Rep. No.989, 95th Cong., 2d Sess. 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5808 (emphasis added)); *see also Johnson v,. Home State Bank*, 501 U.S. 78, 83, 111 S. Ct. 2150, 2153-54, 115 L.Ed.2d 66 (1991) ("Congress intended by [the language of 11 U.S.C. § 101 (5)] to adopt the broadest available definition of 'claim.' ").

[26] *See also In re Hadden*, 57 B.R. 187, 189 (Bankr. W.D. Wis. 1986) ("The fact that the court has some discretion in granting or denying reasonable attorneys' fees does not make [the creditor's] right to attorneys' fees so illusory as to fail to fulfill the definition of a claim.").

The legislative history of the bankruptcy code explains the relationship between debt and claim: "The terms 'debt' and 'claim' are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor."[27] Moreover, the Supreme Court has held that the meanings of the terms "debt" and "claim" are coextensive.[28] Indeed, we have proclaimed that, based on Supreme Court authority, "there is no distinction between 'debt' and 'claim' for purposes of the Bankruptcy Code."[29]

In the absence of a compelling reason why this line of authority would not be applicable to the instant case, we conclude that, as the Parks Group had a "claim" for these expenditures prior to the execution of the Agreement, a "debt" of Southmark also existed for these expenditures prior to the execution of the Agreement.[30] Thus, the $3.3 million transfer was on account of an antecedent debt owed by Southmark.

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[27] H.R. Rep. No. 595, 95th Cong., 1st Sess. 310 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6267; S. Rep. No. 989, 95th Cong., 2d Sess. 23 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809.

[28] *Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 558, 110 S. Ct. 2126, 2130, 109 L.Ed.2d 588 (1990).

[29] *In re Lindsey, Stephenson & Lindsey*, 995 F.2d 626, 628 (5th Cir. 1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 1053, 127 L.Ed.2d 374 (1994).

[30] *See In re Energy Coop., Inc.* 832 F.2d 997, 1002 (7th Cir. 1987) (in the context of analyzing whether a transfer was a preference under 11 U.S.C. § 547, stating that "[w]here a claim exists, so does a debt.").

SR&Z nevertheless argues that for Southmark to prevail on the § 547(b)(2) element in this case, there must be more than the mere existence of a "claim" prior to the exection of the Agreement. SR&Z notes that Congress could have used the word "claim" in § 547(b)(2), but chose instead to use "debt." SR&Z emphasizes that "debt" is defined in § 101 (12) as "*liability* on a claim" and thus denotes a more restrictive concept than "claim," i.e., debt is a subset of claim: all debts are claims but not all claims are debts. This argument, however, is simply unavailing in light of the contrary authorities discussed above.

SR&Z further emphasis that § 547(b)(2) requires that, to be preferential, a transfer must be "for or on account of an antecedent debt *owed* by the debtor before such transfer was made."

SR&Z insists that a debt is not "owed" until the debtor becomes "bound to pay" it; that this "owed" requirement further limits the definition of an antecedent debt. Not only does SR&Z fail to cite any authority for this suspect interpretation of the statute, but such an interpretation is contrary to established law.[31] Accordingly, SR&Z gains no support from this specious argument.

We find inescapable, therefore, that the $3.3 million was transferred "for or on account of an antecedent debt owed by the debtor before such transfer."[32] Although the

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[31] *See id* at 1001 (holding that a creditor's *contingent* claim is a debt for purposes of 11 U.S.C. § 547).

[32] 11 U.S.C. § 547(b)(2).

instant case presents a rare if not unique fact situation, it nevertheless falls within the broad statutory language of the preference statute. This conclusion is not only consistent with the statute and the case law, but also comports with the general observation that a settlement agreement resolves preexisting claims. Accordingly, we reverse the judgment of the bankruptcy court and remand for further proceedings consistent with our opinion.

III.

CONCLUSION

Even though we affirm the bankruptcy court's denial of Southmark's motion for leave to file a second amended complaint, we reverse the bankruptcy court's ruling that the $3.3 million transfer was not "for or on account of an antecedent debt owed by the debtor before such transfer."[33] Accordingly, the judgment of the bankruptcy court is

AFFIRMED in part, REVERSED in part, and REMANDED.

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[33] *Id.*

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

SOUTHMARK CORPORATION, Appellant, vs. SCHULTE, ROTH & ZABEL, et al, Appellees.	§	Bk. Adv. No. 391-3364 Case No. 3:93-CV-0906-X
SOUTHMARK CORPORATION, Appellant, vs. SCHULTE, ROTH & ZABEL, et al, Appellees.	§	Bk. Adv. No. 391-3364 Case No. 3:94-CV-0075-X (Filed Sept. 6, 1995)

MEMORANDUM OPINION AND ORDER

Before the Court is the briefing filed in each of these consolidated appeals from the bankruptcy court. Appellant Southmark Corporation ("Southmark") appeals the bankruptcy court's order entered April 5, 1993 which granted summary judgment for the defendants in the underlying adversary proceeding and granted in part and denied in part Southmark's cross-motion for summary judgment. In addition, Southmark appeals the bankruptcy court's agreed final order entered December 14, 1993 because Southmark had previously been denied leave to amend its complaint. Having carefully considered the arguments of counsel contained in their briefs,

the appellate record, and the applicable law, for the reasons discussed below, the Court determines that the bankruptcy court's orders and judgment should be, and hereby are AFFIRMED.

BACKGROUND

Herbert B. Parks ("Parks"), Appellee Garson L. Rice, Sr. ("Rice"), Appellee R&P Ventures ("R&P"), and Byron Investments, Inc. ("Byron") [hereinafter collectively the "Parks Group"], were shareholders of Southmark prior to Southmark's filing for bankruptcy. On or about March 1, 1989, the Parks Group and certain of their associates disclosed to the Securities and Exchange Commission ("SEC") their intention to propose the Parks Group's nominees for election as members of Southmark's board of directors.

On April 20, 1989 the Parks Group publicly announced their intention to wage a proxy contest for control of Southmark, and about two weeks later disseminated to Southmark's shareholders certain statements in opposition to the Southmark board. The Parks Group indicated in the solicitation materials that they were dissatisfied withthe activities of Southmark's board of directors with respect to issues of corporate governance and management, executive/director compensation, and transactions between the company and its directors and executives. The solicitation materials also disclosed the Parks Group's intention, to the extent legally permissible, to seek reimbursement of their costs and expenses incurred in connection with the proxy contest.

Between February and May 1989 the Parks Group commenced three actions against Southmark in Georgia state court and federal court in Texas, and Southmark commenced two actions against the Parks Group in these courts [hereinafter collectively "the Lawsuits"]. In their claims and counterclaims in the Lawsuits, the Parks Group sought injunctive and similar nonmonetary relief against Southmark, including the right to examine Southmark's shareholder records, a judgment enjoining the use of Southmark's "poison pill," a judgment enjoining Southmark's directors from soliciting proxies unless certain additional disclosures were made, a judgment directing Southmark to cure deficiencies in its proxy statement, and a judgment enjoining Southmark and its directors from postponing a scheduled shareholders' meeting.

In two of the three Parks Group Lawsuits and in the counterclaims asserted in one of the Southmark Lawsuits, the Parks Group sought recovery of their costs and disbursements, including reasonable attorney's fees, from Southmark. In one of the Parks Group Lawsuits, filed in Georgia state court, the Parks Group sought, in addition to injunctive relief, monetary damages from the members of the Southmark board of directors personally in connection with the board's threatened postponement of a scheduled shareholders' meeting. Southmark's by-laws provided that Southmark's directors would be indemnified to the extent permitted under Georgia law. Appellee Schulte Roth & Zabel ("SR&Z") is a New York law firm retained by the Parks Group to represent them in connection with the proxy contest and the Lawsuits.

On May 24, 1989, shortly before a scheduled shareholders' meeting, Southmark and the Parks Group

reached an overall settlement of the proxy contest and the Lawsuits and executed a written settlement agreement ("the Settlement Agreement"). SR&Z was not a party to the Lawsuits, the proxy contests, or the Settlement Agreement. The Settlement Agreement provided for: 1) the termination of the proxy contest; 2) a voice on the Southmark board for minority shareholders, including the Parks Group; 3) the appointment of three nominees of the Parks Group to the Southmark board; 4) inclusion for two years of the Parks Group's three nominees to the Southmark board in the then-current board's recommended slate of nominees; 5) agreement by the Parks Group not to engage in a proxy solicitation in opposition to Southmark or in other takeover activities; and 6) settlement and dismissal with prejudice of the Lawsuits.

The Settlement Agreement also provided for the reimbursement by Southmark of all the expenses, including the attorney's fees, incurred by the Parks Group in connection with the proxy contest and the Lawsuits (initially estimated to be $3,300,000). Section 8 of the Settlement Agreement states in relevant part:

> [Southmark] shall concurrently with the execution of this Agreement deliver to Schulte Roth & Zabel a certified check payable (or make a wire transfer of immediately available funds) to R&P Ventures in the amount of $3,300,000, which the Parks Group represents is a good faith estimate by the Parks Group of (i) its out-of-pocket expenses actually incurred through the date hereof in connection with the Parks Group's activities with respect to Southmark (other than the actual costs of investments and the carrying costs thereof), including without limitation,

> legal fees and expenses, investment banking fees, printing and mailing expenses, proxy solicitation expenses, travel expenses, public relations expenses and telephone expenses, and (ii) with respect to the actions contemplated by Section 12 [of the Settlement Agreement, concerning settlement of the Lawsuits] . . . .

Authorized representatives of Southmark and the Parks Group reached oral agreement as to the essential terms of the Settlement Agreement during the morning of May 24, 1989. At approximately 1:00 p.m. that day, before the Settlement Agreement had been formally executed by all the parties, Southmark transferred the $3,300,000 in settlement funds via a wire transfer from Southmark's bank account in Montana to the Parks Group's counsel SR&Z's bank account at Citibank in New York for SR&Z to hold in escrow until the Settlement Agreement was executed. The settlement funds were to be returned to Southmark by SR&Z if the Settlement Agreement was not executed, and were to be paid to the Parks Group by SR&Z if the Settlement Agreement was executed. The Settlement Agreement was executed in counterparts by all parties at about 5:00 p.m. on May 24, 1989, after the close of the banking day. During the morning of May 25, 1989, the settlement funds were transferred by Citibank at SR&Z's request to R&P's bank account via wire transfer.

Southmark filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989. The Fourth Amended and Restated Plan of Reorganization of Southmark Corporation became effective on August 10, 1990. The present adversary proceeding was

initiated by the filing of Southmark's original complaint on June 19, 1991 against the members of the Parks Group and SR&Z to recover certain transfers made to or for the benefit of the defendants as voidable preferences or unauthorized postpetition transfers under sections 547 and 549 of the Bankruptcy Code. Southmark filed its First Amended Complaint on July 12, 1991. Parks and Byron filed bankruptcy in North Carolina and were subsequently non-suited by Southmark, so that SR&Z, Rice and R&P remained as defendants.

Rice and R&P filed their answer on August 19, 1991, denying that the transfers were preferences or unauthorized postpetition transfers, and asserting affirmative defenses, including the defense of a contemporaneous exchange for new value, that except the payments from being voidable preferences. After extensive but ultimately unsuccessful settlement negotiations, on April 21, 1992, SR&Z filed its answer and counterclaim. On June 16, 1992, Southmark filed a motion for leave to file a second amended complaint. Following oral argument on August 25, 1992, the bankruptcy court denied Southmark leave to amend its complaint from the bench and also by subsequent order entered November 10, 1992. Southmark then filed a motion for reconsideration which was denied by order entered December 1, 1992. Southmark moved for leave to appeal the bankruptcy court's interlocutory order, and Judge Robinson denied leave to appeal on an interlocutory basis without prejudice.

Following a hearing on the transfer matter, by order entered April 5, 1993, the bankruptcy court granted Southmark's cross-motion for summary judgment in part, concluding that the transfers were property of Southmark

and were made within 90 days of the filing of Southmark's bankruptcy petition, that Rice and R&P were creditors of Southmark with respect to the $3,300,000 transfer, and that the transfers enabled the Parks Group to receive more than they would have received if Southmark had been liquidated under Chapter 7 of Bankruptcy Code and the transfers had not been made. The bankruptcy court also granted the defendants' summary judgment motion, concluding that the $3,300,000 transfer of the settlement funds was not made for or on account of an antecedent debt owed by Southmark before the transfer was made. Southmark could not meet this essential element of a preference from § 547(b)(2) of the Bankruptcy Code.

DISCUSSION

The Court has jurisdiction over these appeals pursuant to 28 U.S.C. § 158(a). The bankruptcy court's findings of fact are not to be set aside unless clearly erroneous, while its conclusions of law are subject to *de novo* review. *Matter of Jordan*, 927 F.2d 221, 224 (5th Cir. 1991). The issue presented by Southmark on appeal with respect to the transfer is the same as that before the bankruptcy court: whether the $3,300,000 prepetition transfer by Southmark on May 24, 1989 was made "for or on account of an antecedent debt owed by the debtor before such transfer was made" within the meaning of 11 U.S.C. § 547(b)(2). The issue presented by Southmark on appeal with respect to the denial of leave to file a second amended complaint is: whether the bankruptcy court abused its discretion under Rule 15(a) by denying Southmark leave to amend its complaint before substantial discovery had begun in the adversary proceeding.

The Transfer of Settlement Funds

In § 547(b) of the Bankruptcy Code, Congress broadly authorized bankruptcy trustees to avoid any transfer of an interest of the debtor in property *if* five conditions are satisfied and *unless* one of seven exceptions defined in § 547(c) is applicable. *Union Bank v. Wolas*, 502 U.S. 151, 154 (1991). The dual purposes of the preference section are to discourage creditors from racing to the courthouse to dismember the debtor during his slide into bankruptcy, and to facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. *Id.* at 161, *citing* H.R.Rep. No. 95-595, p. 177-78, U.S. Code Cong. & Admin. News 1978 at 6137-38. The burden of proof as to the avoidability of a transfer under § 547(b) rests with Southmark. 11 U.S.C. § 547(g); *Matter of Cohen*, 875 F.2d 508, 509 (5th Cir. 1989).

The Court concludes, as the bankruptcy court did, that the $3,300,000 transfer of settlement fund was not an avoidable transfer under § 547(b) of the Bankruptcy Code because it was not "for or on account of an antecedent debt owed by [Southmark] before the transfer was made." 11 U.S.C. § 547(b)(2). The Bankruptcy Code defines debt as "liability on a claim." 11 U.S.C. § 101(12). A claim is very broadly defined as a

> right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment,

> fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5). A right to payment is simply an enforceable obligation. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 559 (1990).

Southmark has failed to demonstrate the necessary elements of § 547(b)(2): that there was a debt, that this debt was antecedent to Southmark's payment to the Parks Group, and that the antecedent debt was owed by Southmark. First, there was no debt, or liability on a claim, on the Lawsuits' claims for injunctive relief, and no claim on the Parks Group's request for expenses and attorney's fees until the Lawsuits were settled by the Settlement Agreement. As explained above, the Lawsuits sought injunctive relief only against Southmark – an order giving the Parks Group the right to examine Southmark's record of shareholders a judgment declaring null and void Southmark's "poison pill," an injunction against Southmark's directors soliciting proxies unless certain disclosures were made, a judgment requiring Southmark's directors to comply with the law and cure deficiencies in their proxy statements, and an injunction against Southmark's directors postponing a scheduled shareholders' meeting.

The Parks Group sought no monetary damages against Southmark for the injunctive relief requested in the Lawsuits, so there was no debt or liability on a claim, because there was no claim, as there was no right to payment. Southmark's reliance on *Ohio v. Kovacs*, 469 U.S. 274 (1985) and its progeny is misplaced. The Court agrees with the appellees that while Southmark might have been

required to spend some money in order to comply with the equitable relief sought, the Parks Group had no right to payment, nor could the equitable relief sought been satisfied by any payment to the Parks Group.

With respect to the Parks Group's request for costs and attorney's fees, the bankruptcy court determined, and the appellees concede, that this did give rise to a right to payment in connection with the equitable relief requested so that the Parks Group had a claim against Southmark. This dovetails into the second and third prongs of § 547(b)(2) that the debt must be an antecedent debt owed by Southmark before the transfer was made, because the right to payment (enforceable obligation) did not arise until the Southmark board of directors authorized the reimbursement of the costs and attorney's fees by the execution of the Settlement Agreement. A debt is antecedent under § 547(b) if the debtor incurs it before making the alleged preferential transfer. *Matter of Southmark Corp.*, 55 F.3d 1071, 1073 (5th Cir. 1995). A debtor incurs a debt when he becomes legally obligated to pay it. *Id.* at 1074.

The Lawsuits by the Parks Group, Southmark shareholders, are not analogous to the garden variety tort and contract cases cited by Southmark in which the plaintiff asserts a right to payment arising from the defendant's breach of a duty. In contrast, the Parks Group simply sought to compel Southmark to comply with the law. The bankruptcy court noted in its order that "[had] Southmark taken the corporate action that the Parks Group sought in the proxy contest and related Lawsuits, Southmark would have had no obligation to pay the legal fees

and expenses of the Parks Group." Order at 11. Southmark had no debt, no liability on a claim or legal obligation to pay the Parks Group on the claim for reimbursement of costs and attorney's fees in the Lawsuits, until it chose to settle the Lawsuits, or until the respective courts issued final judgments in the Parks Group's favor and awarded such costs and attorney's fees. The Parks Group could not have filed a suit for these costs and fees alone; they were clearly ancillary to the request for injunctive relief.

Southmark makes much of fact that there was an oral agreement on the morning of May 24, 1989, that the Settlement Funds were later wired from its Montana bank to SR&Z's New York bank *before* the Settlement Agreement was executed that afternoon, and that the funds were transferred from SR&Z to R&P (of the Parks Group) *the following day*. Southmark contends that its debt to the Parks Group was thus antecedent to the $3,300,000 transfer. This interpretation defies common sense and contradicts the plain language of the Settlement Agreement itself. Had the oral agreement reached that morning been fully effective to close the matter, rendering the formal execution of the Settlement Agreement merely superfluous, Southmark would simply have transferred the funds directly to R&P instead of transferring them to SR&Z as escrow agent.

As quoted above, the Settlement Agreement contemplated a contemporaneous exchange, providing in Section 8 that Southmark "shall concurrently with the execution of this Agreement deliver to Schulte Roth & Zabel" its certified check or make a wire transfer of the Settlement Funds. Section 24 provides that the Settlement Agreement

"shall be a binding agreement between the parties thereto upon the due execution of counterparts by the Company, a majority of the members of the Current Board, the members of the Parks Group and the Parks Nominees." The Settlement Agreement is therefore binding upon execution in written form, not when the "parties reached a handshake agreement regarding important terms of settlement" earlier that morning, as Southmark contends. The Settlement Agreement was not executed until about 5:00 p.m. on the afternoon of May 24, 1989, after the close of the banking day so that the funds could not have been transferred until the following day. The Parks Group had the right to the Settlement Funds at the moment of execution, *after* the Settlement Funds had been transferred by Southmark, and the mere fact that its counsel could not deliver the funds until the following business day did not transform the exchange into a transfer made on account of an antecedent debt.

Denial of Leave to Amend the Complaint

Southmark filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989 and instituted this adversary proceeding by filing its original complaint on June 19, 1991. Southmark filed its First Amended Complaint on July 12, 1991, filed its motion for leave to amend its complaint a second time on June 16, 1992, and amended the motion for leave to amend on July 6, 1992. Southmark's proposed Second Amended Complaint introduced five amendments, two of which have since become moot. The three amendments at issue in this appeal would: 1) sue Rice in his capacity as general partner of R&P (he had previously been sued

in his individual capacity only); 2) identify the Sothmark directors sued for money damages by the Parks Group as creditors of Southmark for whose benefit the preferential transfer to the Parks Group were made; and 3) add a new claim for recovery of the $3,300,000 transfer as a fraudulent transfer under U.S.C. § 548.

The bankruptcy court denied leave to amend based on Southmark's unreasonable delay in seeking to amend its complaint a second time. Specifically, the bankrupcty court found that the transactions upon which the proposed amendments are based were known to Southmark when its plan was confirmed in 1990 and when it filed its Original Complaint and First Amended Complaint in 1991. The transactions at issue occurred more than three years before Southmark sought to amend its complaint. The bankruptcy court also noted that Southmark filed these actions with the benefit of the report of the bankruptcy Examiner from 1990 which analyzed potential causes of action Southmark would have under the Bankruptcy Code. Although Southmark had a large and complicated bankruptcy case, the size of the case did not justify Southmark's delay. Finally, the bankruptcy court found that prejudice would result to R&P and Rice if Southmark were permitted to add the fraudulent transfer claim.

Under Rule 15(a) of the Federal Rules of Civil Procedure, leave to amend "shall be freely given when justice so requires." In deciding whether to grant leave to file an amended pleading, the court may consider such factors as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice

to the opposing party, and futility of amendment. *Wimm v. Jack Eckerd Corp.*, 3 F.3d 137, 139 (5th Cir. 1992); *Foman v. Davis*, 371 U.S. 178, 182 (1962). This Court reviews the bankruptcy court's decision denying Southmark leave to amend its complaint under an abuse of discretion standard. *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 546 (5th Cir. 1983).

The Court concludes that the bankruptcy court did not abuse its discretion in denying Southmark leave to amend its complaint. Undue delay alone is a sufficient basis for denying leave to amend. *See Topalian v. Ehrman*, 954 F.2d 1125, 1139 (5th Cir.), *cert. denied*, 113 S.Ct 82 (1992). The Fifth Circuit has affirmed the denial of leave to amend in other cases where, as here, the movant knew the facts relevant to the proposed amendment when its previous pleading was filed. *Barrett v. Indep. Order of Foresters*, 625 F.2d 73, 75 (5th Cir. 1980); *Layfield v. Bill Heard Chrevrolet Co.*, 607 F.2d 1097, 1099 (5th Cir. 1979), *cert. denied*, 446 U.S. 939 (1980).

Southmark's continued attempts (twice before the bankruptcy court, once before Judge Robinson, and once again before this Court) to justify its unreasonable delay in seeking leave to amend its complaint are unavailing. The Court finds particularly disingenuous Southmark's argument before the bankruptcy court at oral argument (and before the Court in its reply brief) that it had only recently learned that Rice was general partner of R&P so that its delay in suing Rice in that capacity was warranted:

> I think having had a number of discussions and after reviewing the first round of written discovery responses, we now have learned as of May

> 21 [1992] that R and P Ventures is a partnership between Rice and Parks. While that may seem, like the name suggests that R and P, we didn't know and we didn't have anything to substantiate that.

Counsel for Southmark, Hearing of Aug. 25, 1992, Transcript at 7. In one of the five Lawsuits that were settled on May 24, 1989, Rice as plaintiff had stated that he was a general partner of R&P. Southmark obviously knew in May 1989 about Rice's status as a general partner of R&P, but waited until June 1992 to decide that it wished to sue him in that capacity. The Court agrees with the appellees that, at best, Southmark was simply unsure about Rice's potential liability, and at worst, Southmark was less than diligent in determining which parties it should sue. This Court will not reward Southmark for such unreasonable delay.

The Court finds Southmark's arguments similarly unpersuasive as to the fraudulent transfer claim and allegation that the Southmark directors were creditors. Southmark asserts that it wasn't until SR&Z's answer was filed in April 1992 that it was clear that all the defendants were taking the position that there was no antecedent debt for which Southmark had paid the $3,300,000 transfer. But Southmark knew when R&P and Rice filed their answer in August 1991 that the antecedent debt element of its preference claims was at issue. Southmark could have pleaded its preference and fraudulent transfer claims in the alternative from the beginning in its original complaint filed in June 1991. The Court finds no abuse of

discretion in the bankruptcy court's denial of Southmark's Motion for leave to amend its complaint because of Southmark's undue delay.

Finally, the bankruptcy court found as an additional basis for denying leave to amend, that Southmark's proposed amendment of its complaint would prejudice R&P and Rice. The Court agrees with the bankruptcy court's reasoning, explained succinctly in its order denying Southmark's motion for reconsideration:

> The liberal rules permitting amended pleadings does not mean that the court lacks discretion to deny amendments under appropriate circumstances. Southmark offers no new arguments in this motion. Southmark has known about its cause of action under 11 U.S.C. § 548 since prior to the confirmation of its plan of reorganization in July 1990. Rather than timely plead, Southmark waited until the defendant had been trapped into a material admission of the element of Southmark's insolvency on the date of transfer before seeking to plead the § 548 cause of action.
>
> In requests for admissions submitted pursuant to Southmark's first amended complaint, the defendant conceded insolvency under 11 U.S.C. § 547. Now Southmark would amend the complaint to add the cause of action under 548 with insolvency already established. Southmark argues that the defendant can withdraw its admission. That cannot remedy the prejudice. The defendant has already admitted to the court Southmark's insolvency. Although the defendant may not otherwise be prejudiced by the amended complaint, the irreparable prejudice of a material admission of an element of a cause of

> action is dispositive. Southmark's undue delay has prejudiced the defendant concerning the admission of that material element.

As with the bankruptcy court's determination of undue delay, the Court finds that the denial of leave to amend on the basis of undue prejudice was not an abuse of discretion.

CONCLUSION

For the reasons discussed above, the bankruptcy court's orders entered April 5, 1993 and December 14, 1993 and judgment are AFFIRMED.

SO ORDERED this 6th day of September, 1995.

/s/ Joe Kendall
Joe Kendall
U.S. District Judge

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ATTORNEYS FOR DEFENDANT
SCHULTE ROTH & ZABEL

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	§	
	§	Case No.
SOUTHMARK CORPORATION,	§	389-36324-SAF-11
	§	
Debtor.	§	

SOUTHMARK CORPORATION,	§	
	§	
Plaintiff,	§	Adversary No.
	§	391-3364
v.	§	(Filed Apr. 5, 1993)
SCHULTE ROTH & ZABEL, R&P VENTURES, AND GARSON L. RICE, SR.,	§	
	§	
Defendants.	§	

ORDER GRANTING DEFENDANTS' SUMMARY JUDGMENT MOTIONS AND GRANTING IN PART AND DENYING IN PART PLAINTIFF'S CROSS-MOTION ON CERTAIN ISSUES

On the 7th day of January, 1993, came on for hearing the Motions for Partial Summary Judgment filed by Defendant Schulte Roth & Zabel ("SR&Z") and the Motion for Summary Judgment filed by Defendants Garson L. Rice, Sr. ("Rice") and R&P Ventures ("R&P") (collectively, the "Summary Judgment Motions"), and the Cross-Motion for Partial Summary Judgment (the "Cross-Motion") filed by Plaintiff Southmark Corporation ("Southmark"); and the Court, after hearing oral argument by counsel for the parties and upon review of the briefs, affidavits and other summary judgment evidence on file in this case, finds and concludes as follows:

1. Rice, R&P and SR&Z filed the Summary Judgment Motions on September 15, 1992, requesting summary judgment on numerous issues set out in Southmark's First Amended Complaint for Avoidance and Recovery of Preferential and Postpetition Transfers (the "Complaint") with regards to the transfer described in the Complaint as the $3.3 Million Transfer.

2. On November 16, 1992, the parties entered into a Stipulation Regarding Motions for Summary Judgment (the "Stipulation") which was approved by the Court. According to the Stipulation, the January 7, 1993 hearing on the Defendants' Summary Judgment Motions was limited to:

a. the issue raised by SR&Z, Rice and R&P of whether the $3.3 Million Transfer was made for or on

account of an antecedent debt owed by Southmark before the transfer was made as required by section 547(b)(2) of the Bankruptcy Code, and

b. the issue raised by Rice and R&P of whether the $3.3 Million Transfer is protected by the contemporaneous exchange for new value defense contained in section 547(c) of the Bankruptcy Code. Defendants Rice and R&P subsequently withdrew this issue from consideration at the hearing.

3. On or about December 7, 1992, Southmark filed its Cross-Motion seeking the following determinations:

a. that the $3.3 Million Transfer, the $9,208 Transfer, the $10,651.64 Transfer and the $50,000 Transfer (collectively, the "Transfers") sought to be avoided in the Complaint constituted transfers of Southmark's property;

b. that the $3.3 Million Transfer, the $9,208 Transfer and the $10,651.64 Transfer (the "Alleged Preferential Transfers") were made to or for the benefit of a creditor as required by section 547(b)(1) of the Bankruptcy Code;

c. that the Alleged Preferential Transfers were for or on account of an antecedent debt owed by Southmark before the Alleged Preferential Transfers were made as required by section 547(b)(2) of the Bankruptcy Code;

d. that the Alleged Preferential Transfers were all made within ninety (90) days of the petition date as required by section 547(b)(4); and

e. that the Alleged Preferential Transfers enabled the Defendants to receive more than they would have been entitled to receive if Southmark had been liquidated under chapter 7 of the Bankruptcy Code and each

Alleged Preferential Transfer had not been made as required by section 547(b)(5) of the Bankruptcy Code.

4. Each Defendant stipulated as to the elements set out in paragraphs 3(a) and (d), above. Defendants Rice and R&P stipulated as to the element set out on paragraph 3(e), above. All other elements raised in Southmark's Cross-Motion for Partial Summary Judgment were submitted to the Court for determination.

5. No disputed issues of material fact exist with respect to the issues being submitted to the Court in Defendants' Motions for Partial Summary Judgment and Southmark's Cross-Motion for Partial Summary Judgment, and summary judgment is proper as set forth below.

6. The ruling of the Court is based on the following undisputed facts:

a. On or about March 1, 1989, R&P, Rice, Herbert B. Parks ("Parks"), and Byron Investments, Inc. ("Byron") (collectively, the "Parks Group") and certain associates of the Parks Group, disclosed to the Securities and Exchange Commission their intention to propose the Parks Group's nominees for election as members of the board of directors of Southmark. At the time, the members of the Park Group were all shareholders of Southmark. On April 20, 1989, the Parks Group publicly announced its intention to wage a proxy contest for control of Southmark, and approximately two weeks later disseminated to Southmark's shareholders certain statements in opposition to the then current board of directors. The Parks Group

indicated in its solicitation materials that it was dissatisfied with the activities of Southmark's board of directors in regards to, among others, issues of corporate governance and management, executive/director compensation and transactions between the company and its directors and executives. The solicitation materials also contained a statement that, to the extent legally permissible, the Parks Group intended to seek reimbursement of the costs and expenses incurred by it in connection with the proxy contest.

b. In connection with the proxy contest, the Parks Group commenced three actions against Southmark in Georgia state court and Texas federal court (the "Parks Group Lawsuits"), and Southmark commenced two actions against the Parks Group in Georgia state and federal courts (the "Southmark Lawsuits"), between February and May 1989 (collectively, the "Lawsuits"). SR&Z, with the assistance of local counsel, acted as counsel for the Parks Group in connection with the proxy contest and the Lawsuits.

c. In the Parks Group Lawsuits and in counterclaims asserted in one of the Southmark Lawsuits, the Parks Group sought a variety of forms of injunctive and similar nonmonetary forms of relief, including the right to examine Southmark's record of shareholders, a judgment enjoining the effectiveness of, and declaring null and void, a Southmark "Poison Pill", a judgment enjoining the Southmark directors from soliciting proxies unless certain disclosures were made, a judgment directing the Southmark directors to cure deficiencies in their proxy statement and a judgment enjoining Southmark

and its directors from postponing a scheduled shareholders' meeting. In two of the three Parks Group Lawsuits and in the counterclaims asserted in one of the Southmark Lawsuits, the Parks Group requested that it be awarded the costs and disbursements, including reasonable attorneys' fees.

d. In one of the Parks Group Lawsuits, filed on May 22, 1989 in Georgia state court, the Parks Group sought, in addition to injunctive relief, monetary damages in connection with the threatened postponement by the Southmark board of a scheduled shareholders' meeting. The Parks Group only sought this relief from the directors of Southmark personally, and not from Southmark itself. Southmark's By-Laws provided that Southmark's directors would be indemnified to the extent permitted under Georgia law.

e. An overall settlement of the proxy contest and the Lawsuits was reached and documented by the 24th of May, 1989. The substance of the settlement is more fully described in the Settlement Agreement dated May 24, 1989 (the "Settlement Agreement"), entered into between Southmark, the Parks Group, and certain other individuals. SR&Z was not a party to the Lawsuits, the proxy contest or the Settlement Agreement. The Settlement Agreement provided for, *inter alia*, the termination of the proxy contest, a voice on the Southmark board for minority shareholders (including the Parks Group), the appointment of three nominees of the Parks Group to the Southmark board, the inclusion for two years of the current nominees in the board's slate of nominees recommended for election, the agreement by the Parks Group not to engage in a proxy solicitation in opposition to

Southmark or other takeover activities and the settlement and dismissal with prejudice of the Lawsuits.

f. The Settlement Agreement did provide for the reimbursement of all the expenses, including the attorneys' fees, incurred by the Parks Group in connection with the proxy contest and the Lawsuits. Section 8 of the Settlement Agreement is entitled "Reimbursement of Expenses" and provides as follows:

> [Southmark] shall concurrently with the execution of this Agreement deliver to Schulte Roth & Zabel a certified check payable (or make a wire transfer of immediately available funds) to R&P Ventures in the amount of $3,300,000, which the Parks Group represents is a good faith estimate by the Parks Group of (i) its out-of-pocket expenses actually incurred through the date hereof in connection with the Parks Group's activities with respect to Southmark (other than the actual costs of investments and the carrying costs thereof), including, without limitation, legal fees and expenses, investment banking fees, printing and mailing expenses, proxy solicitation expenses, travel expenses, public relations expenses and telephone expenses, and (ii) with respect to the actions contemplated by Section 12 [of this Settlement Agreement]. [Section 12 concerned settlement of the Lawsuits.]. . . .

g. Authorized representatives of Southmark and the Parks Group reached oral agreement as to the essential terms of the Settlement Agreement late in the morning of May 24, 1989. At approximately 1 o'clock p.m. on May 24, 1989, before the Settlement Agreement had been formally executed by all parties thereto, Southmark transferred the Settlement Funds via a wire transfer from Southmark's

bank account at First Bank Havre in Havre, Montana, to SR&Z's bank account at Citibank, N.A. in New York. The Settlement Funds were to be returned to Southmark by SR&Z if the Settlement Agreement was not executed, and were to be paid to the Parks Group by SR&Z if the Settlement Agreement was executed. The Settlement Funds were held in SR&Z's bank account for less than 24 hours.

h. The Settlement Agreement was executed in counterparts by about 5 o'clock p.m. on May 24, 1989. During the morning of May 25, 1989, the entire amount of the Settlement Funds was transferred by Citibank, at the request of SR&Z in accordance with the instructions of its client, to R&P's bank account, via wire transfer.

i. The Settlement Agreement provided for Southmark to nominate certain members of the Parks Group (the "Parks Nominees") as members of Southmark's Board of Directors. Section 2(c) of the Settlement Agreement provided, in part, that:

> The Parks Nominees will be entitled to separate independent counsel, the reasonable fees and disbursements of which will be paid by the [Southmark].

j. On or about June 22, 1989, Southmark delivered check number 0152266 in the amount of $9,208.00 (previously referred to herein as the "$9,208 Transfer") to SR&Z for services rendered to the Parks Nominees through May 31, 1989. On or about July 13, 1989, Southmark wire transferred the sum of $10,651.64 (previously referred to herein as the "$10,651.64 Transfer") to SR&Z for services rendered to the Parks Nominees through June 30, 1989.

Additionally, on or about July 13, 1989, Southmark wire transferred the sum of $50,000.00 (previously referred to herein as the "$50,000.00 Transfer") to SR&Z as an "advance payment retainer" for future services to be rendered to the Parks Nominees. Neither the $9,208.00 Transfer, the $10,651.64 Transfer nor the $50,000 Transfer are included in Defendants' Motions for Partial Summary Judgment, but certain elements of the causes of action related thereto are the subject of Southmark's Cross-Motion for Partial Summary Judgment.

k. Southmark filed its petition for Chapter 11 bankruptcy protection on July 14, 1989.

l. The Alleged Preferential Transfers enabled to Defendants to receive more than they would have been entitled to receive if Southmark had been liquidated under chapter 7 of the Bankruptcy Code and each Alleged Preferential Transfer had not been made as required by section 547(b)(5) of the Bankruptcy Code.

7. No genuine issue of fact exists for trial that all the Transfers constituted property of Southmark, that the Alleged Preferential Transfers were made within ninety (90) days of the filing of Southmark's bankruptcy petition, that Rice and R&P were creditors of Southmark with respect to the $3.3 Million Transfer, that the Alleged Preferential Transfers enabled the Parks Group to receive more than they would have received if Southmark had been liquidated under chapter 7 of the Bankruptcy Code and the Alleged Preferential Transfers had not been made with respect to the applicable Defendant, all as required by section 547(b) of the Bankruptcy Code. Therefore,

Plaintiff's Cross-Motion for Partial Summary Judgment should be granted as to these issues.

8. No genuine issue of material fact exists for trial that the $3.3 Million Transfer was not made for or on account of an antecedent debt owned by Southmark before the $3.3 Million Transfer was made. This element of a preference, which is contained in section 547(b)(2) of the Bankruptcy Code, is essential to Southmark's case and cannot be met by Southmark. Therefore, Defendants' Motions for Partial Summary Judgment should be granted, Southmark's Cross-Motion for Partial Summary Judgment on this issue should be denied, and the cause of action set out in the Compliant for the recovery of the $3.3 Million Transfer should be dismissed.

9. The underlying dispute that arose prepetition in the proxy contest and the related Lawsuits is one dealing with corporate governance as it applies to Southmark. The corporate governance issue is an equity matter which does not give rise to a right to payment, and therefore, does not constitute a claim under section 101(5)(B) of the Bankruptcy Code. However, the affiliated request for costs and attorneys' fees by the Parks Group did give rise to a right to payment in connection with the equitable relief requested. Therefore, the Parks Group had a claim against Southmark.

10. In order for a payment to be preferential, section 547(b)(2) of the Bankruptcy Code requires that a payment be for or on account of an antecedent debt owed by the debtor before the payment is made. While claim and debt are ordinarily synonymous, this is not always the case. Had Southmark taken the corporate action that the Parks

Group sought in the proxy contest and related Lawsuits, Southmark would have had no obligation to pay the legal fees and expenses of the Parks Group, and therefore, Southmark would have had no liability to the Parks Group for the payment of any costs and attorneys' fees. Therefore, in this case, no right to payment came into play and no debt was owed by Southmark to the Parks Group until the proxy contest and related Lawsuits were settled in accordance with the terms of the Settlement Agreement.

11. While the definition of the word "liability" is broad, the Court must read section 547(b)(2) of the Bankruptcy Code in its entirety. In that section, Congress has emphasized that the debtor had to have had an obligation to make the payment before the payment sought to be avoided is made. Here, Southmark had no obligation to make the monetary payment until the proxy contest and related Lawsuits were settled in accordance with the terms of the Settlement Agreement. Therefore, the $3.3 Million Transfer was not made for or on account of an antecedent debt owed by Southmark before the $3.3 Million Transfer was made, and Southmark cannot meet its burden of proof under section 547(b)(2) of the Bankruptcy Code on this issue.

12. The Court would not reach a different result based on policy reasons. First, while it appears that the Defendants get to keep the $3.3 Million Transfer, which was made a few weeks prior to the filing of Southmark's bankruptcy petition, while more traditional trade creditors and bondholders would not be able to keep such a payment, this result is not as inequitable as it appears. To the extent a trade creditor or bondholder is required to

return a preferential payment to a debtor, the trade creditor or bondholder gets a claim in the bankruptcy case and shares in the dividends distributed to all such creditors. Defendants, however, are not creditors of Southmark in the traditional sense. R&P and Rice were shareholders of Southmark, and any claim they had based on corporate governance issues could have been resolved without any liability for expenses and legal fees. As interest holders, their interests would have been eliminated in the bankruptcy case unless they made a contribution to the reorganization or otherwise persuaded the creditor body to let them keep some interest. SR&Z was not a creditor of Southmark with respect to the $3.3 Million Transfer.

13. Second, section 547 of the Bankruptcy Code is, by its nature, unfair to individual creditors, although it is fair to the estate and creditors generally. Therefore, it must be strictly construed by the Court to apply to only those situations where Congress determined it should apply. Where one draws the line in how broadly to apply the section is a matter for Congress and not this Court.

14. Third, Southmark appears to be after the wrong defendants. Southmark has asked the Court to look at the ultimate economics of the Settlement Agreement and the $3.3 Million Transfer. The directors of Southmark were the other defendants in the Lawsuits. They are the ones who benefitted from the $3.3 Million Transfer because they were released from multi-million dollars worth of claims by the Settlement Agreement. Success on such claims would have gone to Southmark since they were technically part of a derivative action for harm to the corporation. The directors could not have been entitled to any kind of indemnity in such a situation. Southmark has

released these directors from any claims Southmark might have had against them as part of the comprehensive settlement contained in its confirmed plan of reorganization. The Court does not have a problem with this, but the Court must consider the fact that these directors were the beneficiaries of the Transfer Southmark is seeking to avoid in weighing the economics and the effect of policy on its ruling.

BASED ON THE FOREGOING, IT IS THEREFORE ORDERED as follows:

1. Plaintiff's Cross-Motion for Partial Summary Judgment is hereby granted in part on the following elements:

a. that the Transfers sought to be avoided in the Complaint constitute transfers of Southmark's property;

b. that the Alleged Preferential Transfers were made to or for the benefit of a creditor as required by section 547(b)(1) of the Bankruptcy Code;

c. that the Alleged Preferential Transfers were all made within ninety (90) days of the petition date as required by section 547(b)(4); and

d. that the Alleged Preferential Transfers enabled the Defendants to receive more than they would have been entitled to receive if Southmark had been liquidated under chapter 7 of the Bankruptcy Code and each Alleged Preferential Transfer had not been made as required by section 547(b)(5) of the Bankruptcy Code.

2. On the element contained in section 547(b)(2) of the Bankruptcy Code, whether the $3.3 Million Transfer

was made for or on account of an antecedent debt owed by Southmark before the $3.3 Million Transfer was made, Defendants' Motions for Partial Summary Judgment are hereby granted and Southmark's Cross-Motion for Partial Summary Judgment on this issue is hereby denied. Therefore, the cause of action set out in the Complaint for the recovery of the $3.3 Million Transfer is hereby dismissed.

3. The Court does not reach the issue raised by Rice and R&P of whether the $3.3 Million Transfer is protected by the contemporaneous exchange for new value defense contained in section 547(c) of the Bankruptcy Code because it was withdrawn from consideration, and the Court's ruling on section 547(b)(2), as set forth above, is dispositive and makes such determination unnecessary.

4. There is no just reason for delay. Therefore, it is hereby ordered that this judgment be entered at once pursuant to Rule 54(b) of the Federal Rules of Civil Procedure and Rule 7054 of the Federal Bankruptcy Rules.

SIGNED this 2 Day of April, 1993.

ORIGINAL SIGNED BY
/s/ STEVEN A. FELSENTHAL
STEVEN A. FELSENTHAL
UNITED STATES
BANKRUPTCY JUDGE

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IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 95-10872

In The Matter Of: SOUTHMARK CORPORATION
Debtor

SOUTHMARK CORPORATION
Appellant

v.

SCHULTE ROTH & ZABEL
Appellee

Appeal from the United States District Court
for the Northern District of Texas, Dallas

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Filed Aug. 1, 1996)

(Opinion 7/2/96, 5 Cir., 1996, ___ F.3d ___)

(August 1, 1996)

Before Politz, Chief Judge, and WIENER and BARKSDALE, Circuit Judges.

PER CURIAM:

The Petition for Rehearing is DENIED and no member of this panel nor judge in regular active service on the court having requested that the court be polled on

Rehearing En Banc, (FRAP and Local Rule 35) the Suggestion for Rehearing En Banc is also DENIED.

ENTERED FOR THE COURT:

/s/ Jacques L. Wiener, Jr.
United States Circuit Judge

CLERK'S NOTE:
SEE FRAP AND LOCAL RULES 41 FOR STAY OF THE MANDATE.

(2)

Supreme Court, U.S.
FILED
NOV 26 1996
CLERK

No. 96-672

In The

Supreme Court of the United States

October Term, 1996

In the Matter of SOUTHMARK CORPORATION,

Debtor.

SCHULTE ROTH & ZABEL,

Petitioner,

v.

SOUTHMARK CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Was a corporation's prepetition payment of dissident shareholders' attorneys' fees and expenses in settlement of litigation in which the shareholders had sought recovery of such fees and expenses made on account of "an antecedent debt owed by the debtor" under section 547(b)(2) of the Bankruptcy Code?

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RESPONDENT'S BRIEF IN OPPOSITION

SOUTHMARK CORPORATION ("Southmark"), Respondent, files this its Brief in Opposition, asking this Court to deny Schulte, Roth & Zabel's Petition for Writ of Certiorari (the "Petition") to review the judgment of the United States Court of Appeals for the Fifth Circuit filed on July 2, 1996. In support of this Request, Southmark respectfully shows the Court as follows:

PROVISIONS OF LAW INVOLVED

11 U.S.C. § 547(b) (section 547 of the Bankruptcy Code) (emphasis on relevant section of statute)

§ 547. **Preferences**

* * *

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(a) on or within ninety (90) days before the date of the filing of the petition; or

(b) between ninety (90) days and one (1) year before the date of the filing

of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 101(5) and (12) (sections 101(5) and (12) of the Bankruptcy Code)

§ 101. **Definitions**

(5) **"claim"** means –

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

* * *

(12) **"debt"** means liability on a claim; . . . .

STATEMENT OF THE CASE

Petitioner's description of the procedural history of this case is accurate, with one qualification. The bankruptcy court's summary judgment order of April 5, 1993 was not "interlocutory at the time it was rendered," as Petitioner described it, but rather was expressly made final by the bankruptcy court pursuant to Fed. R. Civ. P. 54(b). *See* summary judgment order ¶ 4, Appendix A-48.[1]

BACKGROUND FACTS

Southmark generally agrees with the statement of background facts prepared by Schulte, Roth & Zabel ("Petitioner") in this matter. However, there are a few omissions or misstatements which may be material to this Court's determination.

Petitioner characterizes the Parks Group's[2] demands for recovery of its reasonable attorneys' fees and disbursements in three lawsuits as a "boilerplate prayer for relief." Burton Lehman, the Parks Group's lead attorney in the prepetition lawsuits and a partner in the Petitioner

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[1] All references to "Appendix" refer to that contained in Petitioner's Brief.

[2] Unless otherwise defined in this brief, capitalized terms have the same meaning ascribed to them in Petitioner's Brief.

firm, testified at his deposition in the bankruptcy court that this "boilerplate" was not intended to have a lesser significance than any other portion of its pleadings.[3] Petitioner's principal litigator in the relevant litigation, Irwin Sugarman, also testified in his deposition that the attorneys' fee demand had a good faith basis.[4]

Petitioner adequately describes the relief sought in the proxy-related lawsuits, but omits a description of the underlying allegations of wrongdoing on Southmark's part. The Parks Group alleged, among other things, that Southmark had distributed a false and misleading proxy statement in violation of the Securities Exchange Act of 1934 and Rule 14a-9, and had breached its fiduciary duties to its shareholders by adopting a "poison pill" in January, 1989 in order to entrench existing management, had improperly arrogated certain powers to its board of directors, failed to timely hold an annual meeting of shareholders and subjected itself to criminal and monetary penalties by violating the Savings and Loan Holding Company Act.[5]

The May 24, 1989 settlement agreement between the Parks Group and Southmark was reached only a few days before a court-mandated annual meeting of Southmark's shareholders. Petitioners' own proxy solicitation materials recognized that Southmark was then in a state of "financial crisis."[6] Southmark had itself incurred at least

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[3] Rec. 0177a (summary judgment exhibits volume).

[4] Rec. 0358a (summary judgment exhibits volume).

[5] Rec. 0206-0210 (summary judgment exhibits volume).

[6] Rec. v. 4: 0113.

$4 million in legal fees and expenses in the Parks Group litigation and proxy fight by this time.[7] The $3.3 million transfer represented the Parks Group's estimate of its attorneys' fees and other disbursements incurred in the lawsuits and proxy contest. The Parks Group subsequently determined that it was owed an additional $441,732.38 and filed a proof of claim in Southmark's bankruptcy case in that amount.[8]

Southmark emerged from bankruptcy in August, 1990 under a confirmed plan with new management and a mandate to liquidate its assets for the benefit of its former creditors, now its shareholders. Under Southmark's plan, the company's board of directors was reconstituted by its new shareholders.

Finally, Petitioner's statement of facts mischaracterizes the Fifth Circuit's conclusion in this case. The Fifth Circuit did not hold that "a debt can be owed before it is incurred (that is, before the contingency that triggers liability takes place)," as Petitioner suggests.[9] Rather, the court below held that "a 'debt' of Southmark . . . existed for [the Parks Group's] expenditures prior to the execution of the [Settlement] Agreement." *Southmark Corp. v Schulte, Roth & Zabel (In re Southmark Corp.)*, 88 F.3d 311, 317 (5th Cir. 1996), Appendix A-14.

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[7] Rec. 0328 (summary judgment exhibits volume).

[8] Rec. v. 6: 0515.

[9] Petitioner's Brief 8.

REASONS FOR DENYING THE PETITION

SUMMARY

The Fifth Circuit properly rejected Petitioner's argument that a "debt" arose out of thin air when the prepetition settlement agreement was reached in this matter. Settlement agreements which terminate litigation resolve preexisting claims against, and liabilities of, the respective parties and typically produce a release of those preexisting claims and liabilities. The present case was no exception.

In its effort to secure a writ from this Court, Petitioner has mischaracterized the issue for review by repeatedly asserting that the Parks Group held only a "contingent claim" against Southmark prior to the $3.3 million settlement payment. A claim for attorneys' fees arising from a breach of duty to shareholders on the part of a public corporation may be disputed and unliquidated, but it is no more "contingent" than the claim of any other injured plaintiff prior to judgment. Nor did the Parks Group's claim against Southmark arise by contract. Thus, the Court's review of this case will not resolve any perceived uncertainty among the courts of appeals about the point at which a contingent, executory contract gives rise to a "debt" under the Bankruptcy Code.[10]

This Court has consistently held that the meanings of "claim" and "debt" in bankruptcy are coextensive, relying on the plain statutory language of the Code. These decisions uphold Congress' express intention that "all

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[10] 11 U.S.C. § 101 et seq. (hereinafter, the "Code").

legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."[11] The Code long ago abolished the distinction between provable and nonprovable claims, a reform which Petitioner effectively invites this Court to reconsider. Petitioner has failed to demonstrate any disagreement among the courts of appeals that a disputed, unliquidated claim for attorneys' fees and disbursements creates a corresponding disputed, unliquidated debt owed by the debtor, nor has Petitioner made any other showing of appropriate grounds for review under Rule 10.

A. UNDER ESTABLISHED PRECEDENT OF THIS COURT, THE PARKS GROUP'S CLAIM GAVE RISE TO A CORRESPONDING DEBT OF SOUTHMARK.

Petitioner concedes that the Parks Group had a claim against Southmark prior to the settlement agreement which produced the $3.3 million transfer. *See, e.g.*, Petitioner's Brief 9, 14. All of the courts below likewise determined that the Parks Group's litigation demands for reimbursement of its attorneys' fees and disbursements constituted a "claim" within the broad definition contained in the Code.[12] *See* 11 U.S.C. § 101(5). However, Petitioner's contention that a creditor may somehow hold a claim against the debtor without any corresponding

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[11] H.R. Rep. No. 595, 95th Cong., 2d Sess. 309 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6266; S. Rep. No. 989, 95th Cong., 2d Sess. 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5808.

[12] Appendix 13, 27, 44.

debt to the creditor flies in the face of established precedent of this Court.

In *Pennsylvania Dep't. of Public Welfare v. Davenport*, 495 U.S. 640 (1990), this Court confronted the issue whether restitution obligations amounted to dischargeable debts in bankruptcy. Examining statutory definitions of "claim" and "debt" ("liability on a claim"), the Court noted the "expansive language" in both definitions, "reflect[ing] Congress' broad rather than restrictive view of the class of obligations that qualify as a 'claim' giving rise to a 'debt.' " *Id.* at 558. The definition of debt, the Court concluded, "reveals Congress' intent that the meanings of 'debt' and 'claim' be *coextensive.*" *Id.* (emphasis added). The *Davenport* decision was expressly rooted in legislative history describing the definition of "claim" as the "broadest possible" and noting that the Code "contemplates that all legal obligations of debtor . . . will be able to be dealt with in the bankruptcy case." *Id.* (*citing* H.R. Rep. No. 95-595, 2d Sess. 309, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6266 and S.Rep. No. 95-989, 2d Sess. 22, *reprinted in* 1978 U.S.C.C.A.N. 5808). The Court further observed in *Davenport* that Congress had likewise adopted the "broadest possible" definition of debt in 11 U.S.C. § 101(11). *Id.* at 563-64.[13]

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[13] "The terms 'debt' and 'claim' are synonymous and refer to a single obligation as seen from the point of view of the debtor and creditor; a debtor has 'debts' and a creditor has 'claims.' " *In re Jordan*, 166 B.R. 201, 202 (Bankr. D. Me. 1994). *See also* legislative history to 11 U.S.C. § 101(11), S. Rep. No. 989, 95th Cong., 2d Sess. 23 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809 ("The terms 'debt' and 'claim' are co-extensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor").

The Court reaffirmed the coextensive nature of claims and debts in *Johnson v. Home State Bank*, 501 U.S. 78 (1991). In the context of determining the extent of a chapter 13 discharge, the Court noted:

> A bankruptcy discharge extinguishes "the personal liability of the debtor with respect to any *debt*." 11 U.S.C. § 524(a)(1) (emphasis added). As we explained in *Davenport*, "debt," which is defined under the Code as "liability on a claim," 11 U.S.C. § 101(12) (1988 Ed., Supp. 3), has a meaning coextensive with that of "claim" as defined in § 101(5). [*citing Davenport*]. Hence, a discharge under the Code extinguishes the debtor's personal liability on his creditor's claims.

Id. at 85, n.5.

Johnson makes an important point. The broad definition of "debt" is integral to the workings of the Code, going to the ultimate issue of the extent of a discharge in bankruptcy. Under any narrower definition of "debt," creditors' claims which fail to qualify as debts would survive bankruptcy because only "debts" are discharged under the Code's provisions. *See* 11 U.S.C. §§ 727(b), 1141(d)(1)(A), 1228(a) and 1328(b).

Petitioner would have this Court hold that certain claims do not rise to the level of debts, at least in the preference context. However, "[t]he Code defines 'claim' and 'debt' for the purposes of the entire title, not individual sections." *Lindsey, Stephenson & Lindsey v. Federal Deposit Ins. Corp. (In re Lindsey, Stephenson & Lindsey)*, 995 F.2d 626, 628 (5th Cir.1994), *cert. denied*, 114 S. Ct. 1053 (1994). To accept Petitioner's argument, therefore,

requires this Court to reach either of two singularly unattractive results. Either a "debt" has a narrower definition for preference purposes than elsewhere in the Code, or the definition of "debt" generally employed throughout the Code is more limited than previously thought. There is neither any textual basis in the Code nor any expression of congressional intent for the former result. The latter result would wreak havoc in the interpretation and application of numerous Code provisions which rely upon a consistently broad definition of "debt." In fact, Congress intentionally abandoned the pre-Code distinction under which only "provable" claims could qualify as debts in bankruptcy, while "nonprovable" claims were left unresolved by the debtor's bankruptcy case. *See* 2 COLLIER ON BANKRUPTCY ¶ 101.05 at 101-56 (15th ed. 1996); *Hoenig v. Hoffman (In re Hoffman)*, 33 B.R. 937, 940 (Bankr. W.D. Okla. 1983).

Nor did Congress' use of the phrase "*liability* on a claim" in defining "debt" signal a more constricted definition than that for "claim," as Petitioner supposes. "Liability" is defined in the leading law dictionary as follows:

> The word is a broad legal term of the most comprehensive significance, including almost every character of hazard or responsibility, absolute, contingent or likely. It has been defined to mean: all character of debt and obligations; . . . condition of being actually or potentially subject to an obligation; . . .

BLACKS LAW DICTIONARY 914 (6th ed. 1990). *See New York Credit Adjustment Bureau, Inc. v. Just-in Materials, Designs, Ltd. (In re Vasu Fabrics, Inc.)*, 39 B.R. 513, 517 (Bankr. S.D.N.Y. 1984) (rejecting preference defendants' argument

that the definition of debt "carries with it the requirement that the debtor's obligation be an established or conceded one, not merely one asserted against it;" citing the BLACKS definition); *accord Energy Cooperative, Inc. v. Socap Int'l, Ltd. (In re Energy Cooperative, Inc.)*, 832 F.2d 997, 1001-02 (7th Cir. 1987) ("when a creditor has a claim against a debtor – even if the claim is unliquidated, unfixed or contingent – the debtor has incurred a debt to the creditor.").

The Fifth Circuit determined in this case that the Parks Group's litigation demands for reimbursement of its attorneys' fees and disbursements created not only a claim but also a debt in Southmark's bankruptcy case for all purposes, including that of preference recovery. It carefully premised its decision upon the plain meaning of the statute, the ample legislative history and this Court's above-cited precedent. There is simply no dissent among the courts of appeals about the coextensive nature and functional equivalence of a "claim" and a "debt," nor has Petitioner cited this Court to any disagreement about this central proposition. Thus, the grant of a writ of certiorari in this case would not clarify the law nor resolve any issue of public importance, but would yield only a reexamination and reapplication of settled bankruptcy law.

B. THIS CASE WILL NOT RESOLVE ANY UNCERTAINTY REGARDING DEBTS ARISING FROM CONTINGENT OR EXECUTORY CONTRACTS.

Petitioner invites this Court to review this case on the basis that it will settle the question whether the existence

of a claim *always* creates a debt.[14] Petitioner insists that there is a "confusing and conflicting body of case law" regarding when a contingent claim gives rise to a debt in bankruptcy.[15] In its effort to show a conflict among the courts of appeals, however, Petitioner has managed to cite only a string of cases involving *contingent contract* claims. This Court's review of this case would not likely resolve any of the asserted conflicts because it involves neither a contingent claim nor one that arises by contract.

Petitioner presents this Court with a comparison of preference decisions which have attempted to fix the date upon which a debt arose in order to determine if it was antecedent at the time of the transfer. It is significant that in each such case, there was a *contract* between the parties with payment due upon the satisfaction of some contingent event such as passage of time or performance. *Compare, e.g., Upstairs Gallery, Inc. v. Macklowe West Dev. Co., L.P. (In re Upstairs Gallery, Inc.)*, 167 B.R. 915 (Bankr. App. 9th Cir. 1994) (payment upon lease termination was made on account of debt incurred on date lease was executed) *with Southmark Corp. v. Marley (In re Southmark Corp.)*, 62 F.3d 104 (5th Cir. 1995) (severance payment was made on account of debt arising at time of breach of employment

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[14] Petitioner's expansive framing of the issue in this case is not particularly illuminating. Even if review of this matter is granted, this Court would most likely exercise its customary restraint and decide only the issue before it. That issue is simply whether the Parks Group's claim in *this* case – and claims with like characteristics – constitute debts for purposes of the Code, not whether every claim always constitutes a debt under all circumstances.

[15] Petitioner's Brief 8.

agreement, not upon execution of employment agreement), *cert. denied*, 116 S. Ct. 815 (1996); *Nolden v. Van Dyke Seed Co. (In re Gold Coast Seed Co.)*, 751 F.2d 1118 (9th Cir. 1985) (debt incurred at time seeds were delivered and debtor became liable to pay for them, as opposed to date upon which executory contract for their delivery was executed); *Iowa Premium Serv. Co., Inc. v. First Nat. Bank in St. Louis (Iowa Premium Serv. Co.)*, 695 F.2d 1109 (8th Cir. en banc 1982) (debt for interest payments on a note incurred when money used, not when note signed). The issue before those courts, then, was whether the debt on account of which the preferential transfer was made arose (1) at the time the contract or instrument was executed by the parties, or (2) at the time the debtor breached the contract or the contingent event occurred.[16]

This central issue in the contingent contract cases cited by Petitioner does not present itself in the case at bar. Rather, the litigation between the Parks Group and Southmark arose from alleged breaches of legal or tort duties, not duties arising out of any contract. The Parks Group sued Southmark for numerous breaches of fiduciary duty to its shareholders beginning in January, 1989, including its adoption of a "poison pill" to thwart a hostile takeover and entrench existing management, use of a proxy statement containing false and misleading

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[16] Significantly, none of these decisions hold that a claim may exist for some period of time independently of any corresponding debt. Rather, they address the time at which the creditor's claim *and* the debtor's corresponding debt simultaneously arise. *See, e.g., Marley*, 62 F.3d at 106; *Nolden*, 751 F.2d at 1119; *Iowa Premium*, 695 F.2d at 1111; *Upstairs Gallery*, 167 B.R. at 917-18.

statements and omissions of material fact, the failure to timely convene an annual meeting, and violation of other federal statutes subjecting Southmark to penalties, among others.[17] The Parks Group incurred enormous proxy and litigation expenses to expose and rectify the wrongdoing of Southmark's prepetition management, and continuously sought recovery of its attorneys' fees and disbursements from courts of competent jurisdiction. By contrast, a party to a contract ordinarily cannot bring suit to recover under its provisions unless and until the other party has breached the contract, a substantial point of distinction between the present case and those cited by Petitioner.

Petitioner's classification of the Parks Group's claim against Southmark as "contingent" is a misnomer. Contingencies are creatures of contract, not torts. BLACKS LAW DICTIONARY defines a "contingent debt" as "[a] debt in bankruptcy which may be proved and allowed *and which arises out of contract.*" *Id.* at 321 (emphasis added). *See also In re McGovern*, 122 B.R. 712, 716 (Bankr. N.D. Ind. 1989) ("If the debtor's obligation to a creditor has already come into existence and is capable of being enforced the claim is noncontingent; references to tort claims as contingent "are the result of careless usage and the failure to properly distinguish between concepts of contingency and liquidation").

In cases involving preferential payments on account of debts arising from torts or other breaches of legal

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[17] *See* Counterclaim of the Parks Group at 8-12 (Rec. 0206-0210 (summary judgment exhibits volume)).

duties, courts uniformly look to the time of the debtor's misconduct (or breach of duty) to determine when the debt was incurred. *See, e.g., Bioplasty, Inc. v. First Trust Nat. Ass'n (In re Bioplasty, Inc.)*, 155 B.R. 495, 499 (Bankr. D Minn. 1993) (preferential payment by debtor to settle claims for securities violations, misrepresentations and other torts); *Imperial Corp. of America v. Milberg, Weiss, Bershad, Specthrie & Lerach (In re Imperial Corp. of America)*, 144 B.R. 115 (Bankr. S.D. Cal. 1992) (payments to plaintiff's attorneys in securities class action in settlement of suit); *Vasu*, 39 B.R. at 517 (payments in settlement of claims for copyright infringement, unfair trade practices and unfair competition).

Petitioner apparently concedes that a debt necessarily arises at the time of the debtor's breach. *See* Petitioner's Brief 23 (hypothetical). Even in the contingent contract cases cited by Petitioner, it is clear that a debt arises for preference purposes *no later than* the time of the debtor's breach. *See, e.g., Marley*, 62 F.3d at 105.

Before the $3.3 million transfer and settlement in the present case, The Parks Group had identified numerous breaches of fiduciary duty by Southmark to its shareholders. The Parks Group commenced a proxy fight and litigation against Southmark in several courts, seeking corrective, injunctive relief, exposing proxy misstatements by Southmark's incumbent management and forcing the company to call a shareholder's meeting. This Court established the entitlement of shareholders to recover their attorneys' fees from a corporate defendant in litigation involving false or misleading proxy statements – even though litigation may never produce any

monetary recovery – in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 391-92 (1970).[18]

A plaintiff establishes a common benefit sufficient to recover its attorneys' fees under *Mills* if it is able to show that its efforts "informed corporate suffrage" by exposing material proxy misstatements. *Id.* at 396. The right to recover reasonable attorneys' fees and expenses continues regardless of whether the plaintiff's civil action is mooted by corrective action on the part of the corporate defendant. *See Maher v. Zapata Corp.*, 714 F.2d 436, 457-58, n.38 (5th Cir. 1983) (shareholders' derivative action; plaintiff's suit was at least a contributing factor in several beneficial changes by corporation and therefore "plaintiff was *entitled* to reimbursement for attorneys' fees and costs"); *Lewis v. Anderson*, 692 F.2d 1267, 1270-71 (9th Cir. 1982) (despite voluntary dismissal of derivative claims, plaintiff could recover attorneys' fees for benefit to corporate shareholders); *Ramey v. Cincinnati Enquirer, Inc.*, 508 F.2d 1188, 1194-96 (6th Cir. 1974) (plaintiffs in derivative and proxy suit were entitled to recover attorneys'

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[18] In *Mills*, the Court concluded:

> The fact that this suit has not yet produced, and may never produce, a monetary recovery from which the fees could be paid does not preclude an award based on this rationale [of unjust enrichment]. Although the earliest cases recognizing a right to reimbursement involved litigation that had produced or preserved a "common fund" for the benefit of a group, nothing in the cases indicates that the suit must actually bring money into the court as a prerequisite to the court's power to order reimbursement of expenses.

396 U.S. at 392.

fees, despite lack of any monetary recovery by corporation, the impossibility of assigning value to the benefit, or the prejudgment action of the corporation to moot their suit), *cert. denied*, 422 U.S. 1048 (1975). The lead lawyer employed by Petitioner in its representation of the Parks Group testified in his deposition that it was both his and the Parks Group's expectation that they were conferring a benefit upon Southmark shareholders by virtue of the proxy contest.[19]

Petitioner's speculation that "the only way to show substantial benefit [on the part of the dissident shareholders] is to succeed in taking over the company" is simply unfounded. *See* Petitioner's Brief 15, n.15. Had Southmark filed bankruptcy before settling with the Parks Group, the Parks Group clearly would have been able to assert a claim in Southmark's bankruptcy case, with a corresponding debt on Southmark's part. *See In re Hadden*, 57 B.R. 187, 189 (Bankr. W.D. Wis. 1986) (even though claim for recovery of attorneys' fees from debtor was unadjudicated and discretionary at time of bankruptcy, it was nonetheless dischargeable as a debt).

The contract cases cited by Petitioner to justify review in this case are inapposite for another reason. Between the time of its execution and the time of breach, a contract is ordinarily considered executory, with material performance due on the part of both parties. *See Nat. Labor Relations Board v. Bildisco and Bildisco*, 465 U.S. 513, 522, n.6 (1984). Executory contracts are subject to a

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[19] *See* deposition transcript of Burton Lehman (Rec. 0172a (summary judgment exhibits volume)).

unique set of rules in bankruptcy, whereby the trustee may ultimately decide to assume a contract as a postpetition obligation of the estate, or to reject it, creating only a prepetition claim against the estate. *See* 11 U.S.C. § 365; *In re Norquist*, 43 B.R. 224, 225 (Bankr. E.D. Wash. 1984) (discussing purposes of § 365). In its *Marley* decision, the Fifth Circuit relied upon the provisions of section 365 in concluding that "a party to an executory contract has a claim against the debtor only when the debtor has rejected the contract." 62 F.3d at 106; *see also In re Jolly*, 574 F.2d 349, 351 (6th Cir. 1978) (other party to an executory contract has no claim until the debtor rejects the contract), *cert. denied*, 439 U.S. 929 (1978). Petitioner's hypothetical about an executory contract between "Betty Jo" and "Bubba" thus misses the mark because it fails to account for the effects of section 365.[20] Therefore, review of the present case could not fully resolve any uncertainty in the law as to when debts arise from breached executory contracts since the latter situation involves unique substantive considerations.

Courts have uniformly rejected the ultimate argument which Petitioner makes in this case: that there was no preference because no debt arose until Southmark agreed to settle the litigation claims against it. Until that time, Petitioner argues, there were disputed or contingent claims, but no debt because no judgment had been rendered nor liability conceded. *Contra Energy Cooperative,*

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[20] Petitioner's hypothetical is further misleading because Petitioner too quickly assumes that a contingent claim necessarily arises at the time an executory contract is made, in spite of authority to the contrary. *See Jolly*, 574 F.2d. at 351.

832 F.2d at 1003; *Bioplasty*, 155 B.R. at 499; *Vasu*, 39 B.R. at 517. "A later compromise of a claim is of no effect as to when a debt arose." *In re Bob Grissett Golf Shoppes, Inc.*, 44 B.R. 156, 159 (Bankr. E.D. Va. 1984). The Fifth Circuit properly refused to adopt the false baseline for the creation of the debt suggested by Petitioner. Permitting preferential transferees to manipulate the antecedent debt element by repackaging a disputed debt as a new settlement obligation would seriously undermine the use of the preference remedy.

C. PETITIONER'S ARGUMENT THAT AN ANTECEDENT DEBT IS ONLY "OWED" IF A DEBTOR IS LEGALLY OBLIGATED TO PAY FINDS NO STATUTORY OR JUDICIAL SUPPORT.

The relevant element of a preference claim requires that the transfer be made "for or on account of an antecedent debt owed by the debtor before such transfer was made . . . " 11 U.S.C. § 547(b)(2). Petitioner insists that the Fifth Circuit erred by failing to read the word "owed" in the statute as imposing an additional requirement that the debtor be "legally obligated" to pay the debt. Petitioner's Brief 26-27. The Fifth Circuit aptly described this argument as "specious" inasmuch as it finds no support in the language of the Code, its legislative history or in any case law.[21] The novel interpretation advanced by Petitioner would effectively limit preference liability to only those creditors to whom absolute, incontestable obligations are owed.

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[21] 88 F.3d at 317, Appendix 16.

No preference decision has ever embraced Petitioner's narrow reading of section 547(b)(2). Petitioner is able to muster only *In re Brennan*, 187 B.R. 135 (Bankr. D. N.J. 1995) in support of this proposition. Petitioner's Brief 20, n.20. However, *Brennan* only addressed whether an attorney qualified as a disinterested professional person under section 327(a) of the Code even though, among other things, he might have received a preference. Although the court suggested in dicta that the word "owed" should be construed to add some meaning to the prior term "antecedent debt," it hastened to add that its conclusion was without prejudice to the right of any party challenging the transfer to argue for a different conclusion of law since none of the parties had argued or briefed the antecedent debt issue. *Id.* at 153. In contrast, the numerous preference decisions permitting recovery of preferential transfers made on account of disputed or unliquidated debts attest to the unsoundness of this proposition. *See, e.g., Energy Cooperative*, 832 F.2d at 1002; *Bioplasty*, 155 B.R. at 499; *Vasu*, 39 B.R. at 518 ("Had Congress wished to exclude payment of undisputed, unliquidated, or contingent claims from the scope of Code § 547(b), it could have done so.").

The use of "owed" in section 547(b)(2) is more consistent with the commonly understood meaning of this word: to bear or to be indebted to.[22] An examination of Congress' use of the word "owed" in connection with

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[22] *See* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 843 (1984) (defining "owe" to include the following: "to have or bear . . . to be under obligation to pay or repay . . . to be indebted to . . . to be in debt").

debts elsewhere in the Code and its legislative history confirms this interpretation. For example, in the legislative history to section 101, the drafters noted:

> The terms "debt" and "claim" are co-extensive: a creditor has a "claim" against the debtor; the debtor *owes* a "debt" to the creditor.

S. Rep. No. 989, 95th Cong., 2d Sess. 23, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5809 (1978) (emphasis added). Elsewhere, in section 523(a)(3), a debt which the debtor fails to list on its schedules to the "creditor to whom such debt is *owed*" is non-dischargeable, even though the debt owed may be an unliquidated tort claim for fraud or for willful and malicious injury by the debtor. *See* 11 U.S.C. § 523(a)(3)(B), (4), (6) (emphasis added).

A natural reading of section 547(b)(2) thus indicates that Congress was simply clarifying that, in order for a preference to occur, the payment cannot be on account of another party's antecedent debt, but only that of the debtor. This reading comports well with Congress' expressed purposes in enacting the preference statute: "to deter creditors from dismembering the debtor during his slide into bankruptcy" and to promote equal distribution among the bankrupt's creditors. *See Energy Cooperative*, 832 F.2d at 1002-3, *citing* H.R. Rep. No. 595, 95th Cong., 2d Sess. 309, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139.[23]

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[23] The Bankruptcy Review Commission report cited by Petitioner is not helpful in this matter since its proposed language following the term "antecedent debt" was entirely discarded by Congress in favor of the final version and does not appear in the relevant House and Senate bills. *Compare* REPORT OF THE COMMISSION IN THE BANKRUPTCY LAWS OF THE UNITED STATES,

Petitioner's interpretation confounds, rather than advances, these expressed policies of Congress under the Code by permitting creditors holding disputed, unliquidated or contingent claims to dismember a debtor with impunity, to the prejudice of creditors generally.[24]

CONCLUSION

Although this case presents a somewhat unusual fact pattern, it offers no material distinction that would remove it from the application of well established Code principles. The Parks Group's claims against Southmark – whether they are characterized as disputed, unliquidated, or even contingent – nonetheless constituted "debts" from their very inception. The plain language of the Code and this Court's precedent establish that a claim and a debt are, by definition, mirror images of one another, and one cannot be artificially manipulated without doing injury to the fabric of the Code.

The only uncertainty in the law concerning bankruptcy debts which Petitioner has been able to identify arises wholly in the context of contingent contract claims.

H.R. Doc. No. 93-137 (1973) *with* H.R. Rep. No. 595, 2d Sess. 372 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6328; S.Rep. No. 989, 95th Cong., 2d Sess. 87 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5873. *See* Petitioner's Brief 28.

[24] Congress expressed concern that certain provisions in the pre-Code preference statute "defeat[ed] the policy of the preference statute by limiting recoveries to only the most egregious cases," prompting a number of amendments under the Code. H.R. Rep. No. 595, *supra*, at 178.

Review of this case would do little to resolve that uncertainty, however, since executory contracts trigger unique bankruptcy issues. Nor will this case answer the question whether a contract debt arises at the time a contract is executed or when some contingency is later satisfied. Moreover, in the eighteen (18) years since the Code's enactment, no court has embraced Petitioner's novel argument that the word "owed" in section 547(b)(2) significantly limits the class of debts which may give rise to preferences.

This case involves only a reaffirmation of settled law to new facts and is therefore not appropriate for review under Rule 10 standards. Petitioner's request for a writ of certiorari should therefore be denied.

Respectfully submitted,

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No. 96-672

In The

Supreme Court of the United States

October Term, 1996

In the Matter of SOUTHMARK CORPORATION,

Debtor.

SCHULTE ROTH & ZABEL,

Petitioner,

v.

SOUTHMARK CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Petitioner, Schulte Roth & Zabel LLP ("Petitioner" or "SR&Z"), respectfully submits the following Supplemental Brief in Support of its Petition for Writ of Certiorari, in accordance with Sup. Ct. R. 15.8, in order to bring to the Court's attention a new case out of the United States Court of Appeals for the Eight Circuit, *Laws v. United Missouri Bank of Kansas City, N.A.*,[1] which further illustrates the conflict among the Circuits on the questions presented herein.

I. Introduction

On October 30, 1996, Petitioner submitted its Petition for Writ of Certiorari seeking review of the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in the above-titled proceeding on July 2, 1996. The questions presented in the Petition are as follows:

1. Whether the existence of a "claim" under section 101(5) of the Bankruptcy Code (Title 11, U.S.C.) always creates an "antecedent debt owed by the debtor" under section 547(b)(2) of the Bankruptcy Code.
2. Whether a debt can be owed before it is incurred.

The Fifth Circuit held, in the opinion below,[2] that a debt can be owed before it is incurred and that the existence of a claim always results in the creation of an antecedent debt. In support of its Petition, Petitioner demonstrated that the holding of the Fifth Circuit on this point of law was in direct conflict with another opinion of the Fifth Circuit[3] and an

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[1] 98 F.3d 1047 (8th Cir. 1996).

[2] *Southmark Corp. v. Schulte Roth & Zabel*, 88 F.3d 311 (5th Cir. 1996).

[3] *Southmark Corp. v. Marley (In re Southmark Corp.)*, 62 F.3d 104 (5th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 815 (1996).

opinion of the Seventh Circuit.[4] In both *Marley* and *Energy Cooperative*, the courts of appeals held that a debt is incurred when the debtor becomes legally obligated or liable to pay the debt, and that in cases involving contingent claims, liability arises and a debt is incurred under section 547(b)(2)[5] when the contingency occurs, and not before. On the other hand, the ruling of the Fifth Circuit in this case is supported by an opinion of the Ninth Circuit Bankruptcy Appellate Panel,[6] thereby creating a conflict among the circuits.

In the recently decided *Laws* case, the Eighth Circuit[7] has now also held, in the context of section 547(b)(2), that a debt must be ***incurred*** before it can be owed, and that in contingent claim situations, the contingency must occur before a debt is incurred. The Eighth Circuit also held that the existence of a claim does not always create an antecedent debt.

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[4] *Energy Cooperative, Inc. v. SOCAP Int'l, Ltd. (In re Energy Cooperative, Inc.)*, 832 F.2d 997 (7th Cir. 1987).

[5] Section 547(b) provides, *inter alia*, that in order for a transfer to constitute a preference, it must be made "for or on account of an antecedent debt owed by the debtor before such transfer was made; . . . " 11 U.S.C. § 547(b)(2).

[6] *Upstairs Gallery, Inc. v. Macklowe West Dev. Co., L.P. (In re Upstairs Gallery, Inc.)*, 167 B.R. 915 (B.A.P. 9th Cir. 1994).

[7] In the Petition, Petitioner did cite to an earlier case out of the Eighth Circuit which determined, in the context of former section 547(c)(2), that the contingency had to occur before the debtor became liable to pay an obligation and before a debt was incurred. *Iowa Premium Serv. Co., Inc. v. First National Bank in St. Louis (In re Iowa Premium Serv. Co., Inc.)*, 695 F.2d 1109 (8th Cir. 1982) (*en banc*). Petitioner noted that while the principles enunciated by the Eighth Circuit in *Iowa Premium* supported Petitioner's analysis of section 547(b)(2), the case might not be considered on point because it dealt with repealed section 547(c)(2). Former section 547(c)(2) required that a debt be "incurred" within 45 days of payment in order to qualify for the ordinary course of business exception to a preference. This language was removed when section 547(c)(2) was amended pursuant to the Bankruptcy Amendments and Federal Judgeships Act of 1986.

Therefore, further conflict has been created between and among the circuits.

II. The *Laws v. United Missouri Bank of Kansas City, N.A.* Case

In *Laws*, the debtor Kroh Brothers Development Co. ("Kroh") was a large commercial customer of United Missouri Bank ("UMB"). UMB gave Kroh immediate provisional credit for all deposits and allowed Kroh to write checks on uncollected deposits. This resulted in two balances in the Kroh account: (i) the "ledger balance", which was the sum of all collected and uncollected deposits, less debits to the account such as checks presented for payment, and (ii) the "collected funds balance", which consisted of collected funds less debits to the account. 98 F.3d at 1048-49.

As Kroh began to experience financial problems, it increasingly used UMB's provisional credits, resulting in a negative collected funds balance of $2.6 million. This caused UMB concern. UMB began charging Kroh interest on its month-end negative collected funds balance. Although Kroh avoided an overdraft position by maintaining a positive ledger balance, its negative collected funds balance continued to grow. Within the applicable preference period,[8] after UMB had informed Kroh that it could no longer permit Kroh to use uncollected deposits, Kroh borrowed $4 million from another bank, wire transferred the funds to its UMB account and effectively eliminated its negative collected funds balance. After Kroh filed for bankruptcy, the trustee sued UMB to recover the $4 million transfer. *Id.* at 1049.

The trustee argued that Kroh's negative collected funds balance was an "antecedent debt" owed by the Kroh to UMB, and that the elimination of that balance had improved UMB's position as a creditor. The district court held that provisional credits constituted an antecedent debt for purposes of section

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[8] For reasons unstated in and not relevant to the opinion, UMB was considered to be an insider of Kroh, and therefore, it was subject to a one year preference period.

547(b)(2), but that the $4 million transfer had not improved UMB's position as a secured creditor and therefore, was not a preference. The trustee appealed. *Id.*

The Eighth Circuit reviewed both lower court findings. In analyzing the antecedent debt issue, the Eighth Circuit made the same analysis of the definitions of "debt" and "claim" made by the Fifth Circuit in this case and by the circuit courts that decided *Marley*, *Energy Cooperative*, *Upstairs Gallery* and others. The Court then determined, based on *Iowa Premium*, that a debt is incurred on the date upon which the debtor first becomes legally bound to pay. *Id.* at 1049-50, *citing Iowa Premium; In re Gold Coast Seed Co.*, 751 F.2d 1118, 1119 (9th Cir. 1985) and 4 COLLIER ON BANKRUPTCY, ¶ 547.10 n.3 (15th ed. 1996). The Court also noted that while the bankruptcy concepts of "claim" and "debt" are "***generally*** coextensive," the determination of whether a debt exists for purposes of section 547(b)(2) does not affect the bankruptcy court's authority to deal with all claims against the debtor. *Id.* at 1049-50 n.3, emphasis added.

Using this analysis, the Eighth Circuit concluded that there were three possible dates upon which a debt based on provisional account credits could be incurred for preference purposes: (i) when the bank provisionally credits the customer's account for the deposited check; (ii) when the customer uses the provisional credit by drawing down on the account before the deposited check clears; or (iii) when the deposited check is, in fact, dishonored. *Id.* at 1050. The Eighth Circuit reversed the ruling of the district court which found that the depositor incurs a debt to the bank when the bank provisionally credits the account for uncollected deposits, regardless of whether the depositor makes use of the credit. *Id.* The Eighth Circuit found that a provisional credit is no more than an opportunity to obtain funds, and therefore, no liability attaches to the customer for its receipt of a provisional credit. *Id.*

The Eight Circuit then analyzed whether routine advances against provisional credits create a debt. The Court determined, based on a decision of the Eleventh Circuit, that until dishonor, a bank that advances funds in the expectation

that deposits will routinely be collected acts as a conduit for the depositor's funds, not as a creditor. *Id.* at 1051, *citing In re Chase & Sandborn Corp.*, 848 F.2d 1196, 1201 (11th Cir. 1988). Given that the test for when a debt is incurred is when the debtor becomes legally obligated to pay and given the rapid nature of the check collection process, the bank has no legal right to recover from the debtor and the debtor has no legal obligation to reimburse the bank until the contingency of dishonor occurs. *Id.* It is the occurrence of the contingency – dishonor – that triggers liability and the incurrence of the debt.

The Eighth Circuit also analyzed the issue from the practical banking law standpoint. Under applicable banking regulations, uncollected funds are excluded from the calculations to determine whether a bank has exceeded its lending limits. *Id.*, *citing* 12 C.F.R. § 32.2(j)(2)(v). This policy comports with the ordinary expectations of the bank and its customer, which is that the customer does not owe a debt to the bank unless and until a check it deposits is dishonored. Therefore, the Court determined that routine advances against uncollected funds would not create a debt owed by the debtor to the bank for preference purposes, even though there might be the contingency of dishonor prior to collection.[9]

The Eight Circuit has, therefore, joined the Seventh Circuit and one panel of the Fifth Circuit, as well as the other courts cited in the Petition, in holding that in contingent claim situations, the contingency has to occur before liability is created and a debt is incurred.

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[9] The Eighth Circuit ultimately determined that under the facts of the case, the advances made by UMB to Kroh had not been routine. Therefore, although it disagreed with the district court's reasoning on the antecedent debt issue, it agreed that summary judgment was not proper. The Court further affirmed the district court's ruling that the transfer was not a preference because it determined that because UMB had a lien on the checks deposited in its account, UMB had not improved its position when the provisional credits were repaid.

III. Applicability to the Case at Bar

In the case at bar, the Fifth Circuit held that a debt may be owed before it is incurred and that the alleged claim of the Parks Group[10] for recovery of costs and expenses incurred in connection with a proxy contest and related corporate governance litigation constituted a debt owed or incurred by Respondent Southmark Corporation ("Respondent" or "Southmark") as of the date the Parks Group first stated its intent to seek such reimbursement in the event it was successful in its proxy contest and related litigation. However, at that time, at best, the Parks Group only had a contingent claim against Southmark for reimbursement of its proxy contest costs and expenses. While such alleged claim may have also been disputed by Southmark, under the applicable definition of contingent claims, reimbursement of proxy contest expenses was contingent upon Southmark's contractual agreement to pay such expenses either through settlement (as occurred) or the appointment of a capable and friendly board of directors after the Parks Group's success in the proxy contest. *See generally* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES ¶ 11.01, p. 11-3 (1995) (stating that "the significant amount of money and time consumed by a proxy fight, and the ***impossibility of recouping proxy fight costs if the insurgents failed to take control***" make it a less favorable method [than a tender offer] for obtaining control of a corporation) (emphasis added); *see also, Steinberg v. Adams*, 90 F. Supp. 604 (S.D.N.Y. 1950) (after proxy contest is successful, stockholders may vote to reimburse insurgents for expenditures that enabled company to rid itself of policy disliked by majority of shareholders, provided fees and expenses are reasonable and are approved by both board of directors and shareholders.) With regard to reimbursement of litigation expenses, reimbursement was contingent upon a court not only ruling for the Parks Group on the merits, but also finding

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[10] The Parks Group was a group of dissatisfied shareholders of Southmark that waged a proxy contest for control of the Southmark board of directors. Petitioner was counsel to the Parks Group.

that the corporation was benefitted by its actions. *See O'Neill v. Church's Fried Chicken, Inc.*, 910 F.2d 263, 265-66 (5th Cir. 1990) (describing the common law rule that allows shareholders to recover their attorneys' fees from the corporation ***if they show they have conferred a substantial benefit*** to the corporation as a result of their efforts).

Using the same analysis as the Eighth Circuit in *Laws*, the provisional right of the Parks Group to seek reimbursement could not give rise to a debt being incurred until the contingency that gave rise to liability occurred. This contingency occurred when Southmark contractually agreed to reimburse the Parks Group for its fees and expenses pursuant to a settlement agreement (the "Settlement Agreement"), which was executed on the very same date the newly-created debt was paid. Until the moment the Settlement Agreement was executed, as a matter of law, Southmark had no liability on any contingent claim of the Parks Group for reimbursement of costs and expenses.

Just as the Eighth Circuit found further support for its bankruptcy law analysis in banking law and practice, a similar non-bankruptcy law analysis can be done in this case. According to Generally Accepted Accounting Principles (GAAP), which governs public companies such as Southmark, a company is supposed to disclose significant risks and uncertainties. One of the most common types of loss contingencies is pending or threatened litigation, ***claims*** or assessments. Jan R. Williams, Miller GAAP Guide 1997, pp. 7.05-7.06 (Harcourt Brace 1997). Such loss contingencies ***must be*** disclosed if they are "probable" or "reasonably possible." *Id.* If the alleged claim of the Parks Group to recover its costs and expenses in mounting a proxy contest was so nonspeculative and noncontingent as to give rise to an "antecedent debt owed" by Southmark as of the very first date the Parks Group stated its intent to seek such reimbursement, Southmark certainly should have been disclosing this very probable loss contingency in its public filings.

No doubt Southmark's accountants never thought such disclosure was necessary or required regarding Southmark's alleged reimbursement obligation. Just as the Eighth Circuit

found that calling routine advances against provisional credits antecedent debts would "immensely complicate" bankruptcy proceedings and destroy ordinary banking relations, so too, would a requirement that the possibility that a dissident shareholder seeking control of a company could, at some time in the future, have its expenses reimbursed further complicate the already complicated world of GAAP and public financial disclosure. Just as the Eighth Circuit held in *Laws*, the Park's Group's reimbursement "claim" was simply too provisional to count as a debt for preference purposes. 98 F.3d at 1052.

IV. Conclusion

The *Laws* opinion creates an additional conflict among and between the circuits regarding the issues involved in the case at bar. ***Every*** preference case should work in reverse – that is, if the preferential payment had not been made, would the creditor have an allowed claim against the debtor for the "debt" the preferential payment allegedly would have satisfied? For example, in the ordinary preference case, within ninety days of bankruptcy, Unsecured Vendor receives $1,000 from Debtor in payment of an old $1,000 invoice. If Unsecured Vendor had ***not*** received the pre-petition $1,000 payment, after Debtor files for bankruptcy, Unsecured Vendor would prepare a proof of claim, attach its invoice to it and file it with the court. Assuming Unsecured Vendor provided the goods or services referenced in the invoice, Unsecured Vendor will have an allowed unsecured claim against Debtor.

This analysis does not work in this case. If, instead of settling the proxy contest and related litigation, Southmark had filed for bankruptcy (which would have equally effectively ended the proxy contest and related litigation[11]), what claim could the Parks Group have asserted against Southmark that would have been an allowed claim in Southmark's case? The only relief requested by the Parks Group in the proxy contest was seats on the board. This relief could not have been asserted as an allowed claim against Southmark in its

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[11] *See* 11 U.S.C. § 362.

bankruptcy case. Nor could the equitable relief requested in the litigation have been asserted as an allowed claim. *See* 11 U.S.C. § 101(5)(b). Therefore, on what basis could the Parks Group have filed a $3.3 million proof of claim for reimbursement of the costs and expenses incurred in mounting the proxy contest and related litigation that had been made moot by the bankruptcy filing? ***The answer must be no basis at all.***

The only documents the Parks Group could possibly have attached to a proof of claim form in support of its alleged $3.3 million reimbursement claim were the complaints in some stayed litigation seeking equitable relief and a proxy statement asking shareholders to vote for a slate of directors different from that being proposed by the debtor company. Southmark undoubtedly would have objected to such a proof of claim on the grounds that it was unenforceable against the debtor because no law or contract required Southmark to reimburse the Parks Group for the costs of an unsuccessful proxy contest. In other words, Southmark would have argued that it had ***no liability*** to the Parks Group on its asserted reimbursement "claim." Therefore, ***no "debt" existed*** under the very exact definition of "debt" set out in section 101(12) of the Bankruptcy Code.[12]

Petitioner cannot imagine what arguments the Parks Group would have asserted in support of such a proof of claim,[13] and such an alleged claim would most likely have been disallowed by the Bankruptcy Court in accordance with section 502(b)(1) of the Bankruptcy Code.[14] Simply put, if there was no Settlement Agreement, the Parks Group would

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[12] Debt means "liability on a claim; . . . " 11 U.S.C. § 101(12).

[13] In actuality, the Parks Group did submit a proof of claim in Southmark's bankruptcy case for an additional $400,000 of unreimbursed expenses. The document attached to the proof of claim form as the legal basis for this claim was the Settlement Agreement – a contract between Southmark and the Parks Group.

[14] 11 U.S.C. § 502(b)(1) provides that a claim should be disallowed to the extent it is unenforceable against the debtor or its property under any agreement or applicable law.

not have had a claim to assert against Southmark for reimbursement of expenses. Logic, therefore, dictates that whatever "claim" for reimbursement the Parks Group had ***must*** have been contingent upon both success in the proxy contest and either a court order requiring reimbursement or the agreement of the new board authorizing reimbursement. Therefore, any resulting "debt owed" could ***only*** have been incurred pursuant to the Settlement Agreement and could not have been antecedent to its payment.

As shown by the *Laws* opinion, confusion continues to exist in the circuit courts on how to deal with contingent claims under section 547(b)(2) of the Bankruptcy Code. A writ of *certiorari* is necessary in this case to insure that section 547(b)(2) is consistently and uniformly applied as written by every court at every level.

Respectfully Submitted,

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